POST FINANCIAL CRISIS SECURITIZATION: CAN (EU) 2017/2402 MAKE ANY DIFFFERENCE?

A CRITICAL ANALYSIS OF REGULATION (EU) 2017/2402

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Tiivistelmä/Referat – Abstract

Following the devastating effect of the financial crisis, the securitization in Europe is still largely impaired and yet to get to the pre-crisis level. There are have been many regulatory interventions to revive the securitization market, with the latest being the regulation (EU) 2017/2402 that will be in force by January 2019. This thesis thus critically examines the regulation in the light of its ability to make a difference in European securitization, and possibly preventing another securitization-induced financial crisis.

First, the rationale and motivations for securitization are highlighted, and possible drawbacks noted. In the same vein, the positives of having the regulation (EU) 2017/2402 are far reaching. For example, with the regulation coming to force, there is the expectation for more transparency, simplicity and standardization of securitization in Europe. The regulation (EU) 2017/2402, while replacing the laws on securitization in Europe, also creates the general framework for securitization and specific framework for simple, transparent and standardized (STS) securitization. The motivation for European securitizes to get the STS tag is that it makes them eligible for differentiated capital requirement of regulation (EU) 2017/2401.

The benefits of the regulation (EU) 2017/2402, however, there are valid concerns about the overall impact on securitization in Europe. This thesis categorizes the concerns to two – sundry concerns and discrepancy concerns. The former relates to the general concerns about the regulation, while the latter expresses the concerns that show differences between what the regulation seeks (as marketed by the authorities), and what is realistically available.

The thesis finally concludes on the note that the European securitization market will be greatly impacted by the regulation (EU) 2017/2402 - there will hopefully be a lot of simplicity, transparency, and standardization or comparability, going forward. In addition, parties in securitization transactions now have more clearly defined roles, e.g. investors now have the responsibility of doing their due diligence before and after holding securitization positions, as well as originators and sponsors providing material information about securitization transactions.

Avainsanat – Nyckelord – Keywords
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LIST OF ABBREVIATIONS

ABCP	Asset Backed Commercial Paper
ABS	Asset Backed Security
AFME	Association of Financial Markets in Europe
ARM	Adjustable Rate Mortgage
CBO	Collateralized Bond Obligation
CDO	Collateralized Debt Obligation
CMBS	Commercial Mortgage Backed Security
CMO	Collateralized Mortgage Obligation
CMU	Capital Market Union
CRR	Capital Requirement Regulation
EBA	European Banking Authority
ECB	European Central Bank
ESMA	European Securities and Markets Authority
EU	European Union
LIBOR	London Interbank Offer Rate
LTV	Loan-to-value
MBS	Mortgage Backed Security
SME	Small and Medium Enterprises
SPV	Special Purpose Vehicle
SSPE	Securitization Special Purpose Entity
STS	Simple, Transparent and Standardized

1 Introduction

This thesis discuses securitization, the latest financial crisis, and Regulation (EU) 2017/2402. The focus is about securitization in Europe[1] and how Regulation (EU) 2017/2402 will plausibly fare in increasing European securitization, with the understanding of the role the securitization played in the financial crisis of 2008. In a way, securitization could be said to mean the process of making assets (those that have cash-generation ability) tradable on the capital market. In other words, simply explained, it means a process of transforming debts to sellable securities.

In response to the financial crisis, the European Parliament and the Council of the European Union, at the end of 2017, passed the general framework for securitization in Europe. The frame work entails elevating the process of securitization to be transparent, simple, and standardized.[2] The regulation (EU) 2017/2402, coming into force by 2019, also doubles as an amendment to Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012. Therefore, this research touches on securitization in Europe, and how it is currently fairing, its link to the financial crisis, and the major themes and concerns of the Regulation (EU) 2017/2402. Specifically, an examination to the Regulation (EU) 2017/2402 is considered in line with possible concerns that Regulation (EU) 2017/2402 may plausibly have.

To be sure, securitization, up to some three decades ago, used to be predominantly an American financial transaction mode.[3] Even after the financial crisis, securitization market is still bigger than the American corporate bond market. [4] It has evolved over time and its definition and usage have also be modified accordingly. Before now, the process of securitization used to be a more simplified arrangement of *''disintermediation''* process. This means the process of replacing issuance of securities for a fresh debt financing, typically loans from bank.[5] Nowadays, its usage are more profound and quite complex and complicated. Unfortunately, securitization is viewed as a less

[1] References are made, however, to securitization outside Europe, where there is need for comparative analysis or for illustrative purposes.
[2] Regulations (EU) 2017/2401 and (EU) 2017/2402 are the latest regulations that covers the concept of securitizations that are simply, transparent, and standardized. They will both enter into force by January 2019.
The acronym STS is duped for the securitization that will be simple, transparent and standardized, Regulation (EU) 2017/2402
[3] Theodore Baums (1996)
[4] Elena Loutsikina (2011)
[5] Frank J Fabozzi and Vinod Kothari (2008)

transparent and somewhat complicated process, hence Regulation (EU) 2017/2402, amongst other intents, aims to improve its opaque and complex nature by making securitizations simple, transparent and standardized.

Securitization is designed as a risk transfer mechanism: transferring of risks from the banks to investors outside the banking sector, so as to spread the risks.[6] Xudong et al[7] define securitization has the system of pooling assets, normally by financial intermediaries, and repackaging and reselling such assets in a pool and collection of new assets. Used for different purposes, securitization implies a financial substitution arrangement where, for example, credit finance is repackaged as capital-market based finance.[8]

The Association of Financial Markets in Europe explains Securitization as *''the pooling together of cash-generating assets, such as mortgages, auto loans or SME loans, created by banks and initially funded on their balance sheets, and funding these assets instead by issuing bonds in the capital markets. These bonds are bought by a range of investors – typically banks' treasury departments, insurance companies and a range of investment funds. The investors receive regular payments reflecting the interest and principal payments made by the underlying borrowers. Often, the bonds are divided into different tranches with different characteristics and varying levels of risk. The higher-risk tranches yield a higher return for investors''*

Securitization, and the laws that have been enacted to improve its operations, is intended to facilitate capital market transactions, improve restructuring, and enable intra-group transactions.[9] In turn, securitization has impacted the way banks play their roles in financial intermediation. Through securitization, banks role have moved from traditional banking to transactional banking, for example.[10] The benefits of securitization regardless, it played a role in the latest financial crisis, maybe not as the primary cause, but it sure amplified the crisis.[11]

[6] Viral V. Acharya, Philip Schnabel, and Gustavo Suarez (2013)
[7] Xudong An, Yongheng Deng, and Stuart A Gabriel (2009)
[8] Andreas A. Jobst (2003)
[9] Deloitte (2018)
[10] Deku and Kara (2017)
[11] European Parliamentary Research Service (2015)

1.1 Securitization Simplified

In simplified terms, securitization is a form of structured finance where there is a pool of assets converted into one or more securities. It involves the redesigning of financial transaction to spread the risks among different people, typically varying classes of investors. So cash-generating assets that have similar features are pooled together. These assets, for example, can be mortgages, banks loans, car loans etc., so long they have similar features in their cash-generating characteristics. Typically, when these loans are granted to the customers, they are booked in the balance sheet of the bank, but these loans are thereafter converted as bonds and issued in the capital market[12]. The new conversion are referred to as asset-backed securities[13]. The issued bonds are purchased by investors who receive regular payments according to their investments. The periodic and regular payments to the investors comprises principal and interest payments and they are from the repayments made by the initial borrowers, i.e. the car loan and mortgage customers. The bonds are structured in tranches with different risk level, and the risk-reward relationship is accordingly arranged so that those with significant risk level are also compensated higher than the others. This means that a tranche that is risky will proportionally returns higher reward.

A distinguishing feature of securitization from other forms of financing is that the pooled, newly generated cash flow can be structured into a higher credit quality. This is not characteristically common with other forms of structured finance. It can also acts as a finance technique where similar income-generating assets are pooled and thereafter sold to a third party, which in turn use them as collateral to insure securities that are sold in financial markets[14]. Securitization, as other structured finance products, has three features – ‘’ (1) pooling of assets (either cash-based or synthetically created); (2) tranching of liabilities that are backed by the asset pool (this property differentiates structured finance from traditional ‘’pass through’’ securitization); (3) de-linking of the credit risk of the collateralized asset pool from the credit risk of the originator, usually through use of a finite-lived, standalone special purpose vehicle (SPV)’’. [15]

[12] AFME (2014)
[13] Frank J Fabozzi and Vinod Kothari (2008)
[14] European Parliamentary Research Service (2015)
[15] A direct quote from Frank J Fabozzi and Vinod Kothari (2008)
The authors were referring to the definition of securitization from the explanation of the structured finance by the Bank for International Settlement (BIS)

There are many parties to a typical securitization transaction, but the most active are ″Original lender, the Originator, the Sponsor, the securitization Special Purpose Entity (or 'issuer'), the Underwriter, the Credit Rating Agencies, the Third-party Credit Enhancers, the Swap counterparty, the Servicer, the Trustee, and the Investors''.[16]

These parties have clearly defined roles, but could have some element of overlap depending on the complexities of a particular securitization transaction. For example the Original lender typically is non-financial entity that has the underlying assets or exposures that needed to be securitized. The Sponsor on the other hand, is usually a financial institution that consolidates the securitization transaction by buying off the exposures from the Original lender. Depending on the structure of the securitization, the Originator also could be a financial institution, typical a bank, credit institution, or an insurance company. The Originator initiates the securitization transactions doing the pooling of income-generating assets and selling to the SPV[17], or by just buying another party's exposures and securitizing them. The Securitization Special Purpose Entity, sometimes interchangeably used for the SPV – the Special Purpose Vehicle, is usually a legal entity, with any form of corporate identities[18] and created for a specific reason of creating the securities and selling then in the market.

The SSPE often turns out to be the issuer, based on its role in the securitization process. The Originator is separated, in principle, from creditors when the transfer is made to the SSPE. The separation or insulation of the SSPE from the creditors is necessary as it guarantees continue paying of obligation even in the case of insolvency. The underwriter acts as an intermediary in the process, typically between the SSPE and the investors, and usually as an investment bank. While acting as an intermediary, the underwriter in conjunction with rating agencies also analyzes the investors' demand and the give general guidance in the overall structuring of the transaction.

Explained in another simplified way, a securitization transaction can happen between lesser number of parties and in a less complicated manner. For example, a Bank grants a customer a mortgage, and the customer makes regular repayments which comprises the principal amount borrowed and the interest. At this point, the Bank is the Originator, and the owner of the asset. The mortgage is a cash-generating asset, because the borrower makes regular payments to the bank. The Bank usually will have many customers that has been granted mortgage loans to and, being the owner of the assets, the

[16] European Parliamentary Research Service (2015)
[17] The SPV means the Special Purpose Vehicle, also sometimes referred to as the SSPE, and as indicated already is usually the issuer of securitization. The SPV is referred to as the issuer because it is set-up for the special purpose of the particular securitization.
[18] It could be Limited Liability Company, a limited partnership, a trust, or even a corporation.

bank can pool similar mortgages together and sell off to another independent entity which has been formed for the sole aim of the securitization. This independent entity is the SPV. So, the SPV purchases the assets from the bank and pays through issuing of bonds to investors. The principal and the interest payment of the mortgage done by the initial borrower is technically towards the SPV, because the SPV now owns the assets. This example is illustrated in figure 1.

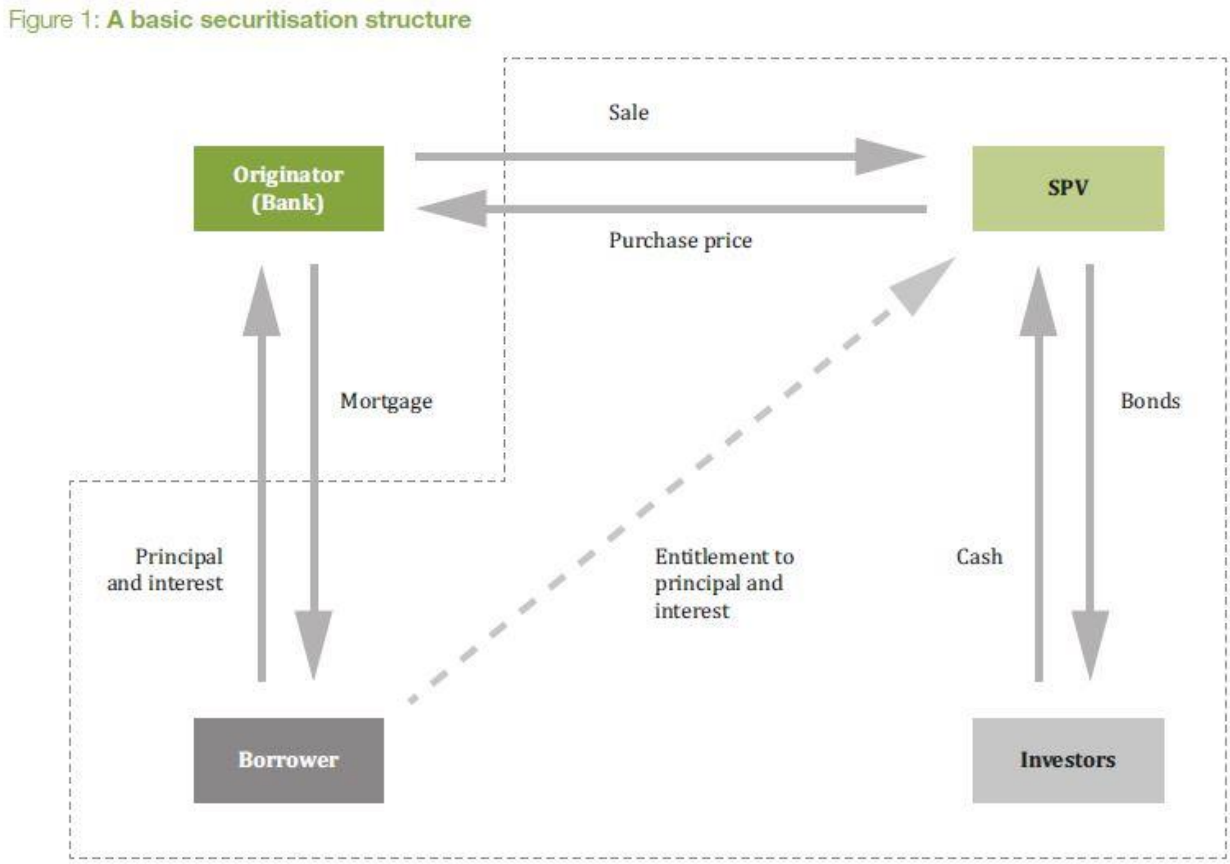

Figure 1: A Basic securitization structure. Source: AMFE (2014

To illustrate how securitization works, here is another example. Assuming a manufacturing outfit decides to sell its products on credit to a customer or group of customers, in this instance, the manufacturing company is the originator. Before granting the credit facility, the manufacturing outfit assesses the ability of the borrower to pay back, according to it set rules, referred to as underwriting standards. If the borrower is assessed to be credit-worthy, the loan arrangement is then created with specific details of repayment plan, including the duration and interest of the loan. Typically, the products or the assets sold on credit double as the collateral. If the originator (the manufacturing firm) needs money, he can sell assets (instead of borrowing) from the proceeds of the promised repayment plan. All he needs do is to set up a Special Purpose Vehicle (SPV) where he details, packages (in tranches and classes) the collateralized loan into assets. He appoints a servicer who manages the repayment plan (the servicing of the loans) from the borrowers. The servicer may be from the manufacturing firm or a totally independent outfit. Thus the new, packaged securities often referred to as asset-backed obligations (ABO) are then offered to investors.

1.2 Rationale and Motivation for Securitization

While there are established economic advantages of securitization, prominent amongst them is reduced cost of lending[19] (when compared to other structured finance). Other economic advantages include the ability to have comparative lower funding costs, seamless transfer and management corporate risks, diversification of funding source, relaxed capital requirement, procuring fee income, and ability to get a possible off-balance sheet funds. In addition, Loutskina[20] submits that securitization surges the level of credit facilities, from financial institutions like banks, to other sectors of the economy.

A well-structured and functioning securitization market acts as an investment avenue for financial institutions and investors. It is also a viable funding instrument to foster lending to banks and other investors. Securitization can as well acts as a medium to generate collateral for credit demands, by its ability to transform illiquid receivables and loans to more liquid assets[21]. The benefits can be viewed from the part of the lenders and originators, the investors, the market, and from social and economic point of view.

First on the part of the lenders and originators

Originators that also doubles as banks for example, can use securitization to upsurge their funding capacity, without necessarily breaching regulatory capital requirements. This is an advantage because while banks are required to maintain their capital in relation to type and size of their assets, they can actually use securitization to release those assets from their balance sheet, and lower the amount of capital that are tied to the capital-asset ratio. So through securitization, additional funding is made

[19] Frank J Fabozzi and Vinod Kothari (2008)
This is primarily viewed from the perspective of the lender. Fabozzi and Kothari opine that compared to other structured finance mechanisms, for example 'factoring', securitization is economic advantageous. For instance the receivables or the loaned articles which may not be acceptable for factoring may be acceptable for securitization. In addition, the cash flows form securitization are almost instant, while in factoring and other similar structured finance the proceeds are not received immediately.

[20] Elena Loutsikina (2011)

[21] European Central Bank and Bank of England (2014)

available. In addition, originators and original lenders can use securitization for the purpose of risk transfer. Here the initial risk associated to the fear that loans will not be serviced are transferred to the investors through securitization. Interest cost are reduced by de-linking the rating of the securitized products from their own original rating.[22]

Furthermore, securitization affords alternative and additional funding options. Generally, banks can make do of securitization as an effective tool to of deleveraging[23], particularly when the loans are non-performing[24]. In Europe for example, the aggregate amount of non-performing loans of the largest European banks, as at the end of 2016 is around half a trillion Euros (net), and the gross is around the same amount, totaling about a trillion Euros altogether. These non-performing loans can be repackaged and restructured for investors through securitization.[25] Not only banks can benefit from the restructuring of legacy assets and non-performing loans, investment firms and credit institutions can use securitization to turn-around non-performing private equity and illiquid hedge fund investments. On the part of the central bank, securitization can be used to achieve target monetary and financial stability goals.[26] Thus summarily, on the part of the 'issuer', securitization provides avenue for converting somewhat illiquid, individual financial assets into tradable, liquid instruments, diversify sources of funds, get lower and effective cost of funds[27], and as well as freeing up the balance sheet off legacy assets with the attendant impressive and resultant financial ratios.

Second on the part of the Investors

Different classes of investors are reached through securitization. Since, there are classes of assets (with homogenous attributes) that are securitized, the needs of all types of investors are met, regardless the level of their risk-averseness and conservatism. It is also possible for securitization investments to be tailored to the specific tastes and desires of investors. A possible attraction for

[22] European Parliamentary Research Service (2015)
[23] The general technique of reducing the level of indebtedness by selling assets.
[24] Deloitte (2018)
Non-performing loans are those that the repayment are not forthcoming as expected or they are not serviced.
[25] Ibid
[26] European Central Bank and Bank of England (2014)
''For example, In the current fragile macroeconomic environment, for example, high-quality ABS can support the transmission of accommodative monetary policy in conditions where the bank lending channel may otherwise be impaired. In particular, securitization may allow banks to lend without committing too much capital and other sources of funding, and thereby provide indirect market access to groups of borrowers that are otherwise not able to tap markets directly, such as SMEs'' - ECB and BOE (2014)
[27] For example, through securitization, a security with higher rating can be securitized at a lower interest rate.

securitization is that, typically, securitization offers more returns on investment than government issued securities of similar maturities. For example, Treasury bill of 10 years pays less than a securitization transaction of similar duration. Often time, this could be as a result of the credit quality of underlying assets, or the sovereign backing of the State on the Treasury bill. Since securitization are referenced with popular bench mark rate, the LIBOR as an example, ‘ securitization can help meet investors’ demands for alternative spread-based investment product, while simultaneously serving basic investment goals of diversification and the risk reduction that may result’.[28] More so, securitization utilizes various degrees and forms of investments, therefore investors can take advantage of the difference in the spread of their low funding costs and wider margins available in the market. This is also included in endless varieties and flexibilities unique payment preferences that investors can have.

Third on the market

When securitized assets are offered for investments, it establishes publicly available prices and information that are needed in improving the overall market practice. The publicly available information are useful in assessment, analyzing of otherwise complicated trade action.[29] Securitization also helps the credit institutions to have their risks transferred to the capital market specifically. So, the capital market provides additional investment chances investors with varying degree of investment tastes and wants, with differing asset diversification, risks and returns, and maturities, thus making investors to be exposed to mixed or unique investment opportunities in consumer finance, aviation, shipping, vehicles and auto services, real estates *etc* without possibly breaching any investment policies and restrictions.[30]

Fourth on the Social and Economic benefits

The benefits accruable to the specific parties, on the overall cascade to the society. As mentioned earlier, securitization can be used as a tool in achieving specific monetary policy goals. It increases the availability of funds, and reduces the cost of the fund from the primary to the secondary markets. Where there are alternative sources of funds, as securitization provides, more social programmes and policies can be influenced. For example, real estate securitization can be used to pursue housing

[28] The Bond Market Association (1999).
[29] M. Levinson (2014)
[30] Deloitte (2018)

programmes, which in turn provide affordable housing that stimulate growth. Similarly, credit cards securitization can be used to promote availability and ease of acquiring consumer credits and loans.[31]

However, good as securitization may seem, there are also some drawbacks. First, securitization challenges and weakens the banks' conventional borrowing stance. This means that motivation for banks to borrow customers may have ulterior motive, particularly, as hinted above, it could be a chance for an off-balance sheet item, and if not properly monitored and regulated, could be a chance for unethical transaction. For example, an SPV may file for an involuntary bankruptcy in a securitization transaction just in a bid not fulfil its obligation. In another instance, as witnessed from the last financial crisis, there could be outright recklessness in the structure of the securitization. The drawback regardless, there are compelling economic reasons to have securitization, as its positive gains outweigh the drawbacks.

1.3 Research Objectives

The misuse of securitization played a significant role in the financial crisis, and particularly in the amplified the crisis. Consequently, the securitization market is greatly impaired. As part of the post crisis intervention, the latest Regulation (EU) 2017/2402 is made with the intent, amongst other reasons, to make the problems associated with securitization – opacity, complexity, and lack of standardization – reduced by introducing simple, transparent, and standardized securitization. This thesis therefore hopes, amidst other things, to be able to explain in simple terms the use of securitization and its various types and its connection of to the financial crisis. Also this thesis examines interventions from government organs in improving the securitization market in Europe,

[31] The Bond Market Association (1999).
'' Similarly, liquid and efficient secondary securitization markets can reduce geographical and regional disparities in the availability and cost of credit throughout a particular jurisdiction by linking local credit extension activities to national, and increasingly global, capital markets systems. It has also been observed that robust securitization markets facilitate and encourage the efficient allocation of capital by subjecting the credit-granting activities of individual financial institutions to the pricing and valuation discipline of the capital markets. In this fashion, securitization helps to promote the allocation of scarce societal capital to its most efficient uses. From a regulatory and financial markets supervisory perspective, securitization offers a useful mechanism by which financial institutions may shift concentrated credit, interest rate and market risks associated with their portfolio activities to investors and the more broadly dispersed capital markets, thus reducing risks to individual institutions, and systemic risks within financial systems.'' - The Bond Market Association (1999)

and critically examines the Regulation (EU) 2017/2402. Thus specific research objectives of this paper include

i) *Are there connections between securitization, the EU crisis and the financial crisis?*

ii) *What constitutes the key contents of the Regulation (EU) 2017/2402 in relation to the STS eligibility criteria*

iii) *What would be the implication of the Regulation (EU) 2017/2402 to the securitization market in Europe?*

iv) *Are there concerns about the Regulation (EU) 2017/2402?*

1.4 Methodology

Understandably the area of this research is narrow compared to other mainstream financial regulation and as such, there may be relative dearth of research method and resources. However, I try to utilize the use of the *legal dogmatics*[32], also sometimes referred to as the doctrinal method or black letter of the law.[33] This is used by the review of the European Union (EU) statutory provisions, particularly Regulations (EU) 2017/2401 and (EU) 2017/2402. There is also brief touch on the Commission's Guidelines, previously existing Directives on securitization, Capital Market Union and relevant EU agencies' proposals, and Discussion Papers on securitization. I equally review main literature and scholarship on the subject of Securitization. However, there are limited court cases on the subject, therefore, as a limitation, the thesis lacks judicial inputs in the analysis. This is partly because the study is proactively assessing a regulation that will be in force by the start of January 2019. Nonetheless, hopefully, the analysis suffices in assessment of the Regulation 2017/2402.

The thesis is limited to the areas of simple securitizations, in relation to the financial crisis and how the Regulation (EU) 2017/2402 can either hopefully improve it or otherwise. There is no discussion about the mechanics of the calculation derivatives. The mathematical concepts of calculation of risks (for example, as provided in Regulation 2017/2401) are not discussed. Thus, the economics is not discussed, but the legal provision of Regulation (EU) 2017/2402 is reviewed. Occasional and sparing allusion is made to the securitization process of other jurisdictions (for historical or comparison reason) but the EU is the crux of the thesis.

The thesis combines Finance and law. On the one hand, the theoretical finance is explained in the light of the regulatory requirement. On the other hand, both are jointly reviewed as one indivisible whole. My intent is to use financial notion and argument (securitization) to the interpretation and systematization of legal rule (i.e. Regulation 2017/2402) to meet economic objective of how probably the regulation will be efficient. At some point comparative legal analysis is done (where for example, there is the comparison of the EU regulatory response to the financial crisis is compare to the US') in

[32] According to Pattaro E (2005), the use of specific legal method of systematically and analytically explaining the substance of a type of law. According to Aarnio (1997), it also involves the method of interpreting and systemizing legal rules. It may sometimes be loosely interchangeably used as 'analytical study of law' or doctrinal study of law'. Pattaro E (2005).

[33] Mike McConville, Wing Hong Chui (2007), *Introduction and Overview*, in Mike McConville, Wing Hong Chui (Eds.) *Research Methods of the Law* (Edinburgh University Press Ltd) 3,4; Khushal Vibhute, Filipos Aynalem, *Legal Research Methods* (Justice and Legal System Research Institute 2009) 44-50.

the thesis. Summarily, the thesis can be said to be pluralistic (in the sense of using more than one approach) in the research style.

The first chapter introduces the reader to the thesis, where securitization is described and the rationale discussed, alongside research questions and structure of the thesis is explained. The second chapter discusses the subprime mortgage contracts and the EU and Financial crisis. Chapter three discusses the mechanics of securitization, where detailed accounts of types and techniques of securitization are explained. Chapter four discusses some provisions in EU legal acts concerning Securitization and policy response to the financial crisis. The fifth chapter discusses the Regulation 2017/2402 in details, and the sixth chapter discusses the concerns of the Regulation (EU) 2017/2402 and, finally, the seventh chapter concludes the thesis.

2. Subprime Mortgage contracts, Financial Crisis and the EU crisis

This chapter of the thesis provides background and context to the main arguments. So this chapter discusses mortgage contracts, the financial crisis, securitization and the EU crisis. The background information helps the arguments made about the merits and concerns Regulation (EU) 2017/2402. The choice of the themes in this chapter is deliberate, as they are intended to furnish the reader with introductory information to follow the arguments in subsequent chapters. On the one hand, subprime mortgage has a close connection to the financial crisis, and since Regulation (EU) 2017/2402 is about securitization in Europe, I believe it is somewhat beneficial to examine an EU-centric crisis (as a mirror of the financial crisis), and the details about the securitization techniques help the reader to appreciate the importance of the Regulation (EU) 2017/2402. On the other hand, the interplay of these themes, I believe, is relevant to the thorough appreciation of the arguments of the thesis.

There is an established strong link between subprime mortgage contracts, securitization and the financial crisis. The crux of the financial crisis can be traceable to poorly executed contracts, particularly mortgage contracts.[34] The financial crisis and its attendant economic loss should open up possible review of contract law, especially where they affect commercial transactions. Predominantly, almost all stakeholders in the mortgage and financial industry – the borrowers, the lenders, policy makers and regulators – have a portion of blame for the financial crisis[35].

2.1 Mortgages Contracts

All mortgage contracts, regardless if they are prime or subprime, have common semblance in their features and structure. Contracts are capable to regulating the relationships that subsist amongst parties. However, in the negative event of the financial crisis, it is not the inability of contracts to forestall a possible occurrence, but the misapplication (or sometimes outright neglect) of contract doctrines that incapacitated the prevention of the crisis.[36] Specifically, subprime lending began as a direct consequence of the deregulation of the interest rates processes. After the development of policies and procedures that replace the traditional lending products, subprime lending evolved. [37] In addition, the growth and expansion of subprime lending and mortgage is attributable to technological innovations in the computation of complex financial pricing of loans. Mortgage contracts generally have, at the minimum, cost deferral.[38] This means that as either a prime or subprime mortgage

[34] George M. Cohen (2011)
[35] Zywicki T. J and Adamson d Joseph (2009)
[36] George M. Cohen (2011)
[37] Zywicki T. J and Adamson d Joseph (2009)
[38] Oren Bar-Gill (2009)

contract, it is essentially a loan agreement, and hence repayment is expected to be done over a period of time.

Prime vs Sub-prime Mortgage contracts

There are marked differences between prime and sub-primes loans. These differences can viewed from different perspectives – from the borrower, default rates etc. From example, viewed from the perspectives of the borrower, majorly, the difference can be summed up in costs of administering the loan, predominantly in the form of up-front and continuing costs[39]. Viewed from the default rate, the rate of default of subprime lending and mortgage contracts, at least in the United States, largely outnumber the default rate of the conventional, traditional mortgage lending.[40] The conventional non-toxic prime mortgage contract is relatively non-complicated, simple transaction. It is typically structured on a fixed-rate over a 30-year period, and a required 20% advance or down payment.[41] This is normally referred to as the FRM – fixed-rate-Mortgage. On the other hand, a subprime mortgage, as the direct opposite of the prime mortgage, involves a rather complex loan architecture combining adjustable-rate mortgages (ARM) and varying degrees of multifaceted pricing structures.[42] It also has a feature of ending up in the debt profiles of lesser credit-worthy individuals.

From the general perspectives, the nature of the loan arrangement and the schedule of the payment are sacrosanct. The nature of the loan arrangement differentiates both contracts. A viable metric of distinguishing the both contracts is the proportion of the loan required to the value acquired. This is referred to as the loan-to-value – LTV. The loan-to-value ratio is important in granting a loan. As mentioned above, the conventional prime mortgage contracts expects the mortgagor[43] to have 20% of the house value as down payment, implying a ratio of less than 80%.[44] Whereas the subprime mortgage contracts, particularly in the recent months before the crisis, there are documented evidences of loan-to-value exceeding 90%[45].

[39] Benjamin J. Keyes (2008)
[40] Zywicki T. J and Adamson d Joseph (2009)
[41] Oren Bar-Gill (2009)
[42] Ibid *p* 1096
[43] This is the borrower in the mortgage contract who, after the successful execution of the contract, becomes the homeowner.
[44] Oren Bar-Gill (2009)
[45] It is one of the issues raised in the later chapter about the concerns of the Regulation (EU) 2017/2402. It seems to me that the Regulation doesn't consider the contract structure of the underlying asset. This may as well make the Regulation (EU) 2017/2402 Rather comestic.

Securitization of loans will be eventually impaired if the underlying mortgage contract is impaired by not using a reflective LTV ratio. If underlying loan structures are not addressed, it is doubtful the outcome of such derivatives will not be impaired, regardless of the STS tag or otherwise. Worst still, the median of the preceding 32 months[46] before the financial crisis indicates a zero-down payment, meaning a 100% loan-to-value.[47]

In addition, another sub-metric for gauging the difference of both contracts (apart from the nature of the loan agreement, measured by the LTV) is the schedule of payments of the loan. In prime mortgage contracts, the repayments are structured on a fixed-rate basis where the mortgagor pays the same amount regularly. Where an adjustable-rate is applicable, the variation in the amount of money paid is minimal. This is because a pre-determined, constant decimals are added to a fluctuating index (interest rates, typically, and for example, the EUROBOR or LIBOR)[48], that does not cause any significant systemic change in the payment. However, with subprime mortgage, on the other hand, there is an accumulative payment scheme. The true interest rates chargeable are not totally disclosed. Lower rates are set for the introductory period, typically, around the first two years of the contract, and a higher interest rate chargeable in subsequent months.[49]

The general characteristics of the subprime mortgage or lending hence include: the high cost of servicing and underwriting. This is so because, by its very nature, subprime mortgages (are usually securitized) involves lumping homeowners of varying degree of credit worthiness together. More so, usually subprime mortgage holders' investigations are slightly longer and more tedious: holders typically present lesser or incomplete documentations, they have (more often than not) are in relatively unstable employment, tender unusual collateral etc. All these end up hiking the cost of the loan. Amidst the contracts typically used in financial transactions, the adhesion contracts[50] top the list. These contracts, by their very nature, do not leave options for negotiations from the weaken party in the contracts. Normally, financial contracts, and by extension, many mortgages are couched in adhesion contracts.[51] From the origin of the financial crisis, in the United States, adhesion contracts

[46] The median is calculated from 2005, 2006, and the first six months of 2007.
[47] Oren Bar-Gill (2009)
[48]London interbank Offered Rates and EURO interbank Offered Rate, respectively.
[49] Oren Bar-Gill (2009)
[50] Adhesion Contracts implies a standardized contract structure that strengthens or widen the gap between an economically advantaged parties over other parties. It is structured with no chance for negotiation for the weaken party in a contract.
[51] Smith, S (2010)

were evident prior the crisis, just like the previous financial crises before it.[52] That perhaps explains the advantage of the mortgagors in mortgage contracts.

2.1 Securitization and the Financial Crisis

By the fall of 2008, the effect of the financial crisis had resulted in huge bank loss and nationalizations of financial institutions in advanced economies, particularly in Europe and North America. In scale, it is the most devastating since the crisis of 1933.[53] The goodwill and reputation of securitization as a viable means of risk transfer and access to fund has been marred, as a result of the financial crisis.[54] The securitization market in the EU, in particular got impaired. Public issuance of Asset Backed Securities (ABS) got very limited and mostly concentrated in a few jurisdictions[55]. The market significantly reduced. The financial crisis eroded the good image of securitization as the crisis uncovered the execution of complex, risk-laden deals alongside poorly rated assets. In addition, the financial crisis reduced the potentials of banks to provide funding.[56]

Securitization is believed and agreed to have played a prominent role in the financial crisis[57], particularly the abuse of the payment arrangement. In at least four ways, securitization contributed to the financial crisis, directly or indirectly. For example, the subprime mortgage securitization activated the subprime crisis[58], and the subprime crisis was a subset of the financial crisis itself. In the process, subprime mortgage is revealed as perhaps a faulty asset type for securitization. There is also the structural deficiency of securitization that aided the financial crisis. By this, I mean the models or forms at which securitizations are used. For example, the model of originate-to distribute[59] potentially creates moral hazard[60] and securitization creates servicing conflicts as well as overreliance of external validation, e.g. mathematical models or rating agencies[61]. Little wonder many critiques focused on the originate-to-distribute model[62] after the financial crisis. Perhaps the originate-to-distribute model is just symptomatic to the overall capacity of how misused financial innovation can be devastating.

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[52] Ibid
[53] Ray Barell and E. Philipps Davis (2008)
[54] European Central Bank and Bank of England (2014)
[55] *Ibid*
[56] AFME (2014)
[57] Schwarcz (2016)
[58] Schwarcz (2009)
[59] This system is explained in a subsequent section.
[60] Schwarcz (2009)
[61] Ibid
[62] Bavaso (2012)

The Financial crisis had numerous signs prior it eventual existence. In the years preceding the eventual financial crisis, securitization, particularly in the United States, soared remarkably.[63] The increase in securitization activities were not particularly harmful but for the complexities and opacity that surround asset-backed transactions. As theoretically expected, the increase in the volumes of securitization should, under well-functioning market conditions, guarantee transfer and redistribution of risks in the system, however, unfortunately, that did not take place.

The pronounced precursors include low global synthetically created interest rates[64], credit enlargement and soaring asset prices particularly in the real estate and mortgage sector, low short-term real interest rates, high risk financial products[65], in that particular order.[66] Financial institutions therefore, in a bid to meet the high returns from investors, resorted to securitization (and particularly on its ability to be an off-balance sheet item) with little supervision and monitoring. Consequently, banks engaged in risk financial products over the normal level they would have otherwise engaged in[67] because of the seeming 'free cash flow' securitization afforded with high credit ratings most securitization products got. The rating agencies also played major part. Some subprime mortgages were rated good enough to be securitized alongside primes ones. It was not too long before the bubble bust. In addition, the use of securitization, lowered the motivation for credit institutions to properly screen risk borrowers.[68] Borrowers with relatively low credit worthiness were granted loans because of the bundling and repackaging of the loans securitization affords.

Apart from the above mentioned harbingers of the financial crisis, there were other causes of the crisis as it relates to the securitization. In the US, for example, there were policy flaws.[69] Particularly monetary policy errors. To combat internal monetary policy challenges already dating half-a-decade before the crisis, the US had lax monetary policies in response to the bearish equity market of 2003. This corresponds with Rosen's[70] submission that regulatory arbitrage[71] motivates credit institutions

[63] European Central Bank and Bank of England (2014)
[64] According to Barell et al, the interest rates were artificially induced to be low, as many countries, for example china, turn out high liquidity from foreign exchange reserves and current accounts surpluses. In the process, the pressure resulting therefrom caused the artificial low interest rates.
[65] Products like structured finance innovations and sub-prime loans
[66] Ray Barell and E. Philipps Davis (2008)
[67] *Ibid*
[68] Richard J. Rosen (2010)
[69] Ray Barell and E. Philipps Davis (2008)
[70] Richard J. Rosen (2010)
[71] Regulatory arbitrage implies the circumvention of law, essentially monitoring loopholes in legal provisions for gains. For instance, when a bank engages in securitization in other to circumvent capital requirements.

to engage in securitization. In addition, wrong scope of regulation also contributed to the securitization crisis of the financial crisis. The regulation scope of most the central banks did not cover financial innovations and structured finance products. Central Banks and Federal Reserve tend to focus more on the interest rates with little emphasis on price stability. Worst still, micro and macro prudential guidelines and regulation are somewhat disintegrated in advanced economies[72]. For instance, in the US, the micro prudential regulation is fragmented. In the UK, it is detached from the Central Bank, and in the EU, there is no uniform regulator. In other words, in the EU, there are varying degrees of the implementation of financial regulations.

2.2 Originate-to-Distribute Model

Closely connected to the financial crisis was the originate-to-distribute model, particularly of mortgage securitizations. Traditionally, credit institutions fund loans through the deposits received from customers and retain same in the balance sheet, until, typically, the maturity of such loans. This conventional means is called the originate-to-hold model. However, things changed drastically when credit institutions, particularly banks began to extend their funding sources to include commercial paper financing, repurchase agreements, and corporate bond financing.[73] The Originate-to-Distribute Model is thus replaced with the Originate-to-Distribute Model, which means that the prior the maturity of the funded by credit institutions, the loans are repackaged into assets and are not retained in the balance sheet. Banks started the distribution with simple transactions like mortgages, credit cards, and students' loans.[74] First with, the process started with loans syndication.[75] This as however metamorphosed to a rather complex arrangement where funds are originated and distributed to wide range of financial transactions and products. As securitization grew, it became rather easy for banks to 'sell mortgage loan that they originated'.[76] The selling of loans, particularly mortgages, was connected to the financial crisis because 'banks sell mortgages as part of the securitization process, but few actually do the securitization'.[77]

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[72] It is one of the reason that this thesis focuses on the Regulation that intends to sanitize and improve the securitization transaction in Europe.
[73] Vital M. Bord and Joao A. C. Santos (2012)
[74] *Ibid*
[75] Loan syndication implies the cooperation of group of borrowers to fund and give out loan to a single debtor.
[76] Richard J. Rosen (2010)
[77] Rosen (2010)

Against the previous originate-to-hold model, the new originate-to-distribute model afforded flexibility for credit institutions, particularly banks, to alter the size of mortgages without necessarily altering the entire their entire ‘equity capital or asset portfolio. Consequently, the transfer and management of risks through the Originate-to-Distribute Model caused the start of low quality mortgages.[78] Eventually, ‘banks with excessive involvement in the originate-to-distribute market had incentives to issue inferior mortgage loans, which in turn contributed to the financial crisis'', since through the originate-to-distribute model and securitization, it is possible to profit from origination fees without necessarily bearing risks. Turns out that one of the highlights of the Regulation (EU) 2017/2402 is the ban of the Originate-to-Distribute Model, in the form of re-securitization. It is yet to be seen how events will unfold in relation to the securitization market.

2.3. Snapshot of Securitization in Europe: Before and After the Crisis

The start of the use of securitization as a financial innovation, on a rather large scale, is essentially traceable to the late 1980[79]. Before then, securitization has only been done in a small scale. As it stands, there are varying degree of the use of securitization in Europe: while some have developed a robust market for it, and even drawn the legal and regulatory framework of its smooth operations, some are just evolving. At the moment, the securitization market in Europe is weakened and impaired.[80] Attempts are made to revive the market, and restore confidence in its operations, particularly after the role securitization played in the financial crisis. The securitization market in Europe has declined quite remarkably after the financial crisis.[81] In figure 2, 3 and 4 attached below, a tabular account of the state of the securitization market is represented. As it stands, the overall pricing of the secured products, particularly asset-backed securities, are impaired because of the poor rating of backing assets, restrictions in European inter-bank lending (from the European Central Bank) and restrictions of insurance companies' use of secured financial products[82]. The indicators of the impaired securitization market in Europe is evidenced by shrunken issuance of Real Mortgage Backed Securities and European Collateralized Debt Obligations, and reduced ratio of number of new

[78] Purnanandam A (2010)
[79] Theodore Baums (1996)
[80] ECB and BOE (2014)
[81] In monetary terms, prior the crisis, the ABS market in Europe was over 1 trillion dollars in 2008. After the crisis, in 2013, it is less than a quarter of a trillion dollars. Altomonte and Bussoli (2014)
[82] Altomonte and Bussoli (2014)

issuance placed on the market and those retained by the originators. There is the steady decline in the issuance of European securitization immediately after the financial crisis.

At the end of the crisis, the total European securitization was almost half a trillion Euros. It has steadily reduced ever since. Currently, at the end of the first half of 2018, the total issuance of European securitization is around 125 billion Euros. Compared to the United States, the European Securitization hasn't totally recovered from the financial crisis. Whereas, the United States total issuance has topped the pre-crisis level (evidenced from the table), the European securitization level is still at about half of its pre-crisis level.

Many countries in the EU are quite active in securitization deals[83]. Issuance based on the country of collateral, using 2017 as the benchmark, the UK has the highest securitization deals, followed by France, Italy, and Spain in that particular order. However, from the available data for this year, 2018, The Netherlands leads in the amount of the issuance of securitization deals. Expectedly, residential mortgage backed securities, RMBS[84] are the most actively issued securitization transaction in this year, followed by asset-backed securitization (ABS), then collateralized debt or loan obligation CDO/CLO. Understandably, many countries in Europe are different level of the development and sophistication of securitization. Each country also has distinct story of how securitization evolved, regulated and how it is currently fairing. For example, special laws guiding securitization was available in French law already before the end of 1980s, while The UK has dedicated securitization market for car loans, tax-based securitization deals, and home equity loans. By the late 1988 there was the FCC (*Fonds Commun de Cr'ances*) and the insolvency laws that complement the French securitization law. Reflective of the Member States' responsibility in the implementation of some EU policies, EU member States oversee and undertake securitization deals within its border, where applicable with the national laws.

In addition, many of the EU countries have developed suitable infrastructure to admit the smooth supervision of securitization, depending on the peculiarities. For example, unlike France, when it started, the UK did not have dedicated laws for securitization. Thus, sectors which the securitized

[83] AFME (2018)
After March 2019, after the successful trigger of the Art 50 of the TFEU, and depending of the outcome of the negotiation with the EU, the UK may seize to be part of the EU.

[84] Other European issued securitization include Small and Medium-Sized (SME) securitization, Commercial Mortgage-Backed securitization (CMBS), and asset-backed commercial paper, ABCP securitizations etc
Regulation (EU) 2017/2402 that will be in force by 2019 has considerable framework for ABCP securitizations.

deals are carried out, monitor the deals. Take for example, while the Bank of England monitors the overall banking affairs to ascertain that capital adequacy measure are in place for banks ''reduced need for capital only if it has no risk from the loans which it has sold'', respective commissions monitors securitizations for products concerning the sector. That is the reason that in the UK, the Building Society Commission, empowered by the 1986 Building Societies Act, issue mortgaged-backed assets. The before-and-after the financial crisis evaluation, the UK's 'new issuance represented almost a third of total European Issuance on average until 2008, but after the peak, UK flows dropped by 90 percent, with new issuance in 2013 representing less than 20 percent of the European total''.[85]

There are potentials for the European securitization market in Europe, if under necessary conditions, the European Central Bank intervenes in the market.[86] The idea of Regulation (EU) 2017/2402 is laudable. It can be combined with the intervention of the European Central Bank. The timely intervention of the ECB in buying existing European asset-backed securities so as to free the on-balance sheet capital of banks to enhance lending and also buying the residential mortgage-backed. As plausible as these conditions are, utmost care is needed to avoid conflicts with fiscal policy measures.[87] This is in addition to the fact that central banks, national authorities and policy makers are increasing the call for reinforcement of the securitization market in Europe.[88]

[85] Altomonte and Bussoli (2014)
[86] Altomonte and Bussoli (2014)
[87] *Ibid*
[88] AFME (2014)

Table 7: **European securitisation default rates: mid-2007 to end 2013**

	Original Issuance (€bn)	Default Rate (%)
Europe		
Total PCS eligible asset classes	960.2	0.15
Credit Cards	33.2	0.00
RMBS	756.0	0.12
Other consumer ABS	68.0	0.13
SMEs	103.0	0.41
Only senior tranches to be PCS labelled, the default rate for which is zero, like covered bonds		
Total Non-PCS eligible asset classes	728.9	5.66
Leveraged loan CLOs	70.6	0.10
Other ABS	69.1	0.00
Corporate Securitisations	64.9	0.13
Synthetic Corporate CDOs	254.4	2.87
CMBS	163.3	10.34
Other CDOs	77.8	6.54
CDOs of ABS	28.9	41.04
Total European securitisation issuance	1,689.1	2.53
Covered Bonds	1,085.0	0.00
Total European issuance	2,774.1	1.54
Select US asset classes		
Credit cards	295.4	0.07
Autos	198.2	0.04
Student loans	266.9	0.34
RMBS	3,254.9	22.05

Source: Standard & Poor's

Figure 2: How European securitization has fared during and after the financial crisis. Source: AFME/S&P

Table 4: **European issuance by collateral and country at Q1 2014 (€bn)**

	Auto	Consumer	Credit Card	Leases	CLO	CMBS	RMBS	SME	WBS/PFI	Total
Germany	2.1	1.4	0	0	0	0	0	0	0	3.5
Italy	0	0	0	0	0	0.1	0	0.7	0	0.9
Netherlands	0	0.7	0	0	0	0	5.3	0	0	6.0
Portugal	0	0	0	0	0	0	0	0.8	0	0.8
United Kingdom	0.6	0	0	0	0	1.3	1.1	0	1.8	4.8
PanEurope	0	0	0	0	2.5	0	0	0	0	2.5
Total	2.7	2.0	0	0	2.5	1.4	6.5	1.6	1.8	18.5

Source: AFME Securitisation Data Reports

Figure 3: Select European countries' underlying assets for securitization after the financial crisis. Source: AFME

1.1 Issuance European Historical Issuance

	Q1	Q2	Q3	Q4	TOTAL
2009	131.0	83.8	113.3	95.8	423.9
2010	75.5	32.6	110.7	159.2	378.0
2011	115.2	67.3	57.1	137.2	376.8
2012	64.3	67.7	62.0	63.9	257.8
2013	32.8	53.2	38.4	56.4	180.8
2014	20.0	99.5	37.8	59.8	217.1
2015	35.7	50.3	57.8	72.8	216.6
2016	57.0	75.8	46.6	60.1	239.6
2017	40.2	73.0	49.1	74.1	236.5
2018	58.5	67.2			125.7

1.2 US and Australia Historical Issuance

	US	AU
2009	1,447.2	9.7
2010	1,245.9	15.5
2011	1,068.9	20.4
2012	1,609.0	14.8
2013	1,565.1	22.4
2014	1,190.9	22.1
2015	1,744.5	19.9
2016	1,860.4	16.4
2017	1,899.3	29.2
2018	779.1	9.1

Sources: Bloomberg, Citigroup, Dealogic, Bank of America-Merrill Lynch, Deutsche Bank, JP Morgan, Macquarie, Thomson Reuters, Unicredit, AFME, SIFMA

1.3 European Issuance by Collateral

	2018:Q1	2018:Q2	2018:Q3	2018:Q4	TOTAL	2017:Q1	2017:Q2	2017:Q3	2017:Q4	TOTAL
ABS	13.0	18.5			31.5	7.8	10.0	12.4	22.7	52.9
CDO/CLO	12.6	15.2			27.8	6.2	14.0	14.8	13.7	48.7
CMBS	0.4	2.0			2.4	0.3			0.6	0.9
RMBS	29.3	29.4			58.6	23.1	41.8	21.6	32.5	119.0
SME	3.1	2.1			5.2	2.8	7.2	0.4	4.5	14.9
WBS/PFI					0.0					
Total	58.5	67.2			125.7	40.2	73.0	49.1	74.1	236.5

1.4 European Issuance by Retention

	2018:Q1	2018:Q2	2018:Q3	2018:Q4	TOTAL	2017:Q1	2017:Q2	2017:Q3	2017:Q4	TOTAL
Placed	32.2	37.7			69.9	16.9	39.6	23.3	31.5	111.3
Retained	26.2	29.5			55.8	23.3	33.5	25.9	42.6	125.2
Total[2]	58.5	67.2			125.7	40.2	73.0	49.1	74.1	236.5

1.5 Australia Issuance by Collateral

	2018:Q1	2018:Q2	2018:Q3	2018:Q4	TOTAL	2017:Q1	2017:Q2	2017:Q3	2017:Q4	TOTAL
ABS	0.3	0.6			0.9	2.4	0.3	1.0	0.8	4.6
RMBS	3.1	5.0			8.1	5.1	6.1	6.3	6.6	24.1
CMBS					0.0			0.3	0.2	0.5
Total	3.4	5.6			9.1	7.5	6.4	7.7	7.6	29.2

1.6 US Issuance by Collateral

	2018:Q1	2018:Q2	2018:Q3	2018:Q4	TOTAL	2017:Q1	2017:Q2	2017:Q3	2017:Q4	TOTAL
ABS	53.9	50.0			103.9	59.4	63.6	40.1	56.0	219.1
CDO	25.9	28.9			54.8	51.4	86.4	54.4	70.1	262.4
Agency MBS	253.2	270.2			523.4	326.3	280.7	311.2	305.1	1,223.3
Non-Agency CMBS	18.8	13.7			32.6	14.4	20.2	23.5	26.3	84.4
Non-Agency RMBS	20.5	43.9			64.4	26.3	34.4	21.8	27.6	110.1
Total	372.3	406.8			779.1	477.9	485.3	451.1	485.1	1,899.3

Sources: Bank of America Merrill-Lynch, Bloomberg, Citigroup, Dealogic, Deutsche Bank, JP Morgan, Macquarie, Thomson Reuters, Unicredit, AFME, SIFMA

Figure 4: Current comparative figure of European, US, and Australian Securitization issuance: Source:

2.3. The EU and the Financial Crisis

Apart from the global financial crisis, the EU had its crisis also. The EU crisis came in diverse forms – financial, economic, unemployment, solvency challenges, credit, and slow economic growth, frictions in the financial system, liquidity and increasing public debt.[89] There are reasons to believe

[89] Tuori, Kaarlo, and Klaus Tuori (2014)

the EU crisis was connected to the financial crisis. The huge impact of the financial crisis amplified the EU crisis. The EU crisis itself was far-reaching and it posed a huge threat to the integrity (and to a large extent) tried to undermine the achievement of the European Union.[90] It cascaded down from the EU central level to the member states too, economically.

To be sure, the nature and the structure of the European Monetary Union[91] itself compounded the crisis. For instance, at its inception, the European Monetary Union was created with the primary goal of price stability, as proposed from the Maastricht Treaty in the form of deficit and debt ceilings. This implies that with the monetary policies being handled centrally and the corresponding fiscal policies left in the hands of the Members States the EMU is a 'fragile mechanism involving self-contradictions'.[92]

In the area of unemployment, the impact of the global financial most certainly impacted the EU. Understandably so, some countries in the Eurozone are impacted than others, with southern European countries more hit. While the initial response of the EU to the global financial crisis had relatively positive impact, say for three years, the situation overturned and moved to austerity.[93]

There are various plausible narratives for the causes of the EU crisis, however, the most compelling and relevant for this thesis is the economic and legal. In the economic narrative, there are symptoms of an ailing EU economy already. These symptoms, of varying proportions, are pointing to an imminent crisis. One of such was the sovereign debt crisis. Sovereign debt crisis occurs when a State cannot meet its financial obligations in settling its borrowed funds and resources.[94]

When States demonstrate their ability to regularly (and perhaps as agreed with the creditors) service their debts, without potentially having to whimsically altering the state's survival, then debt is sustainable. Debt sustainability thus is important because of the possibility of a state to keep on borrowing to service its debts or the debt accumulation keeps growing faster than the state's ability to meet or service its debts.[95] Just as the loan-to-value is crucial in the administration of loans to

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90 Patrick, Stewart M (2010)
91 EMU is the European Monetary Union. It is the Union that brings all the countries that have the EURO as their currency.
92 Patomäki, Heikki.
93 International Labour Office. (2012)
94 Whereas known conventional means of raising funds and resources for states include borrowing from either external means or domestically, taxing businesses and persons, and outright currency issuance. To avoid inflation, it is not unusual for States to recourse to borrowing, particularly when the generate tax funds are inadequate to meet its needs internally.
95 M. Megliani (2015)

private individuals, discussed in previous chapter, Loan sustainability is also crucial on a sovereign, national level. The debt crisis in Greece, and that engulfed part of the Eurozone, particularly the countries that are infamously referred to the PIIGS – Portugal, Ireland, Italy, and Spain – led to significant changes to the economic narrative of the EU crisis.[96] In sum, before the eventual crisis, there are combination trends[97] and contemporary developments that culminated in the crisis.

2.3.1 The Contemporary Events

As highlighted above, the EU crisis was caused by the blend of recent developments and secular trends. Compelling recent developments that triggered the EU crisis, although not exhaustive, include shorter-term economic events and developments.[98] First, the primary consequence and losses of the sub-prime mortgages in the United States erode, at the very least, the confidence in the Financial markets. Admittedly, the spill-over of the effect of the houses crisis in the rest of the world did not show up until around 2007 when the inter-connectedness of the financial systems began to show in Europe and the rest of the world. The loss, however, has been on, albeit in a measured degree in the United States but came to the full glare during the crisis itself.[99] It is arguable whether the State involvement (directly or otherwise) through, for example, the enactment and implementation of housing policies remotely contributed to the eventual collapse of the mortgage crisis that led to the financial crisis.

Consequently, finance and real estate firms started having financial difficulties with rather popular and big firms folding-up. The result was a full-fledged crisis. The response to the crisis took different shapes in different jurisdictions, but one of the common stance was the States' involvement in varying fashions. National governments, mostly through the central banks, either carryout full bail-out or partial bail-out to firms considered too-big-to fail, in an attempt to salvage what was the remaining in the aftermath of the crisis.

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[96] Tuori, Kaarlo (2014)

[97] According to Tuori, Kaarlo, trends can widely vary in accordance to their duration. For example, consistent trends that last up to a decade and more times are referred to as 'secular' trend.

[98] They are referred to shorter terms events, because compared to the secular trends that are at least 10 years of persistent trends.

[99] There are number of merger and acquisitions that are facilitated by government, or direct or indirect State-involved actions of activities that shows the signs of reduced capacities of companies to carry out certain economic activities. Confirmed from the Bank of International Settlement's report of 2009 – JP Morgan Chase takeover of Bear Stearns was State-involved.

It is also arguable if the responses to the crisis in the various fashion from different government[100] is sufficient to curb the crisis then, or a recurrence. The EU had its fair share in the losses. The most hit being, perhaps ironically, the capitalized and interconnected to the rest of the financial system, Germany, for example. Whilst some of the losses, particularly those of market-prices, are expected with time to recover, there were other incurred losses that are somewhat permanent. The impact in the EU admittedly vary from country to country, depending, for example, the macro and micro-economic structural peculiarities of the countries.

In the event of financial crisis of this magnitude, the impact trickles down to the firms, households and individuals. It manifests in the decline spending, reduced accessibility of credits, and the consequent force of sale of assets. The Euroze is perhaps the most affected compared to the rest of the developed countries in the Organization for Economic Cooperation and Development, OECD. The Eurozone, when after other developed OECD countries were showing signs of recovery, was still deep-sit in the impact of crisis. This can be argued if the peculiarities of the Eurozone, such as its composition, can be one the reasons (other than the economics of the crisis), for its delayed recovery.

The EU crisis, especially the one affecting Eurozone[101] is also triggered by the marked economic differences in the countries composing the area. A close look at the rate and speed of the recovery in the Eurozone area reveals that the, expectedly, the countries recovered at different rate. For example, Germany, the strongest and largest economy in the Eurozone, recovered faster than, for example, countries like Italy and Spain. Apart from the rate of recovery, another index for measuring the marked difference in the Eurozone area is the economic peculiarities of the countries[102].

[100] Some of the response, apart from the bail-out funds to the firms considered too-big-to-fail, include increasing collateral for borrowings, additional provision to banks to increase their liquidity and ability to meet customers' demand, direct buy-up of shares and stocks and debts of affected firms and in some cases, governments.

[101] The expression for countries that uses the Euro as their currency.

[102] Greece is a fit in this case. Although undoubtedly severely hit by the crisis, the sovereign debt profile and the historical fiscal responsibility (or otherwise) compounded the problem. I do hold the opinion that structure of the Eurozone, especially the marriage of different economies with varying fiscal structure have a compelling tie to the delay recovery from the crisis. It confirms the fear that the crisis in the Eurozone is not only economic (as described above, other developed OECD countries show recovery signs after the initial shocks, compared to the slow recovery of the Eurozone) but perhaps also its structure.

3. Mechanics of Securitization

In this chapter, the major forms of securitization are discussed. It explores the various types and techniques of securitization transactions and how they are completed. With the focus on the global financial crisis, the immediately relevant types of securitization – mortgage-backed and asset-backed securitizations are discussed. On the one hand Mortgage-backed securitization, as the name suggests, are created from the pool of mortgages, and then reworked and sold to investors. On the other hand, Asset-backed securitization involves other types of assets that are not linked to mortgages[103]. Though there are many ways securitized assets are classified, prominent characteristics in the classification include whether the underlying assets are amortizing or not, and whether mortgage is attached or not.[104]

3.1 Mortgage-Backed ABS

For securitized assets that are mortgaged attached or mortgaged-backed, there are different forms and types. The common ones are listed below:

i) Pass-through

This is also referred to as participation certificate. It is loosely used to describe the resulting structures of CMO[105] securitizations.[106] It is so-called because it entitles the holder of this mortgage-backed securitized asset to direct ownership of pooled mortgaged securities. The name pass-through is derived from the fact that the servicer pass-through the proceeds to the investors. The mortgage loans in the pool comprises, quite normally, varying degrees of maturities. It is also common to have pass-through securitization collateralized by distinct repayment rate – level-pay (where the interest and the principal are structured and scheduled to be same throughout the maturity) or with varying and fixed interest payment. As a common technique of securitization, the pool of mortgaged loans are structured, and as principal and interest payments are made to the pool, ‘’pass-through’’ remittances are made to the investors. It is also known or used as an amortizing structure.[107]

[103] Deka and Kara (2017)
[104] The Bond Market Association (1999)
[105] CMO is an abbreviation for Collateralized Mortgage Obligation. It is discussed in-depth in the next session.
[106] Frank J Fabozzi and Vinod Kothari (2008)
[107] Deka and Kara (2017)

ii) CMO – Collateralized Mortgage Obligations

Collateralized mortgage Obligation is comprised of many pass-throughs. Thus, it is a pool comprising varying degrees and different classes of pass-through mortgage-backed securities and loans, and acts as the primary resulting structure of mortgage securitization.[108] CMO are structured with definite intent. They are sometimes used, as the name suggests, as a collateral for further securitization.[109] Since it comprises pools of pass-throughs, the classes and tranches making up the CMOs have distinct characteristics that satisfy the investment intents of each of the classes. There are different offerings of CMOs. In structural context, they are sometimes referred to as pay through structure. They come in different shades, as explained above, with the intent of meeting the investment objectives of the subscribed holders. The most simple, perhaps, is the *plain vanilla tranches* (and sometimes, called sequential-pay). They are so-called because of the simplicity.[110] This form of CMO is structured in a way that payments from the underlying mortgage loans are remitted, with priority is given to a particular participant or holders of a particular tranche. There is a form of hierarchy in the payment pattern. The tranche in a higher hierarchy receives payment first, and in full, before subsequent tranche receives payment. In essence, all the payments – scheduled or unscheduled principals received from the underlying mortgage loans are paid to the higher tranche, first.

Take for example, in a CMO that has three parts in the transaction, with varying degree of maturity, say for illustration, 6 years, 12 years, and 15 years respectively, the tranche with the 6 years gets it payment first and in full before the tranche of 12 years receives its own. The name 'sequential pay-down' is thus derived from the structure of the payment, as the 'sequential pay-down continues until the last tranche – the security having the longest maturity – is retired' and paid.[111]

Another popular form of a CMO is the planned Amortization (PAC) tranches.

As the name implies this type of CMOs is planned, and structured in way that a buffer or sinking fund is created to mitigate possible fluctuations in the payment arrangement. So alongside the principal tranche, there are other tranches in the arrangement, often referred to as support tranches. They are also sometimes referred to as companion tranches. So the PAC is planned in a way that the principal fund is fixed, provided the ensuing prepayments continue to be within the envisaged range band.

[108] Frank J Fabozzi and Vinod Kothari (2008)
[109] Deka and Kara (2017)
[110] Cornerstone Mortgage (2016)
[111] The Bond Market Association (1999)

When there are fluctuations in the prepayments arrangement, the companion or support tranches are adjusted according to provide the envisaged stability. Thus, the fixed nature of the fund is guaranteed, although PAC thus may need pay on a different principal schedule. Comparatively, the PAC tranche tends to have a stable outlook throughout the maturity. So the PAC is designed to produce a stable cash flow by redirecting the risk of payment through the companion tranches[112]. Typically, it is commonly used because of its relative stability.

Targeted Amortization Class (TAC) Tranches

This tranche works similarly to the PAC. The difference is inherent in the adjustment procedure of the fluctuations of the prepayments. It is essentially a scheduled tranche that remitted on a predetermined prepayment model[113]. With TAC, alongside the features of PAC, additional protection is factored should there be an early redemption. Like the PAC, it also provides more cash-flow certainty, but has (on the average) higher yield than the PAC.

Support/Companion Tranches

These are the tranches that offer support for the fluctuations in the prepayment arrangement of the fund. As explained above, the planned or targeted amortization could have slight changes in the principal fund, occasioned by prepayment fluctuations. Thus the support of the companion tranches are used in the ensuing adjustments, stability and predictable cash flow. Hence the primary roles of the support tranches is to provide absorbing features to the varied prepayments to the principal fund. The variability that the support tranches control works in both ends – first to cushion short fall from the main principal fund, and second, to absorb excesses. Therefore the support tranches are used alongside the PAC and TAC tranches. The life span, typically, for support tranches works hand-in-hand with the interest rates applied. When the interest rates rise, the support tranches' lifespan stretches and when interest rates decline, the lifespan reduces. Because of the rather intense fluctuations and volatility, the support tranches, in compensation, offer slightly higher yields when prepayment is near to the envisaged rate at the time of purchase.[114]

[112] Cornerstone Mortgage (2016)
[113] Ibid
[114] The Bond Market Association (1999)

Z-Tranches

The Z-tranches are structured in the close consideration for the lock-out periods[115]. In a way, they are the riskiest of the tranches because the payment are made after other tranches have been paid[116]. Thus Z-tranches are those that are arranged in a way that no interest is paid in lock-out periods, or any other conditions for that matter. Often times, the Z-tranches are referred to accretion or accrual bonds. For the entire time of the lock-out periods, the Z-tranches holders are not paid interest until the end of the period. This thus means (and ultimately) makes the Z-tranches, during the lock-out period, to have accrued interests. The accrued interests and the face value are credited at the designated coupon rates and agreed payment dates. Soon as there are no other active tranches and the lock-out periods are ended, holders of Z-tranches are then paid the accrued interests, alongside the principal. For its peculiar features, the Z-tranches are usually structured for relatively long term. Compared to (and used alongside) other tranches, for example, the PAC, the Z-traches are the last to tranches.

iii) Stripped Mortgage-Backed Securities

As the name suggests, these securities are mortgage-backed but are rather structured that they are stripped. They are so-called because, unlike the conventional mortgage-backed securities, the cash flow is from strictly interests only or principals only of the underlying mortgages. The distinction makes these securities stripped. Stripped mortgage-backed securities, because of their nature, are somewhat sensitive to interest rate fluctuations. They are often times structured to respect peculiarities and the distinct tastes of various investors. They suit investors with various timing of repayment length and duration. The interest rate risk and exposure structure of stripped mortgage, correspondingly, are inversely related depending on the split – principal only or interest only. This means that when interest rate reduces, the principal only strip increases in price and the price of the principal rate only strip reduces and vice versa.

Thus in principle, there could be many variations in the way the stripped mortgage-backed securities can be structured – principal-only, interest-only, residuals, floating rate tranches etc. Although the most common division is the split between the principal-only and the interest-only stripped mortgage-backed securities. Each with its distinct characteristics designed for the repayment need and tastes of

[115] Lock-out periods are the time, where because of the presence and quite active nature of other tranches, there is relative silence or absence of payment of interest.
[116] Cornerstone Mortgage (2016)

the investors, alongside desired flexibilities as the case may warrant. For the principal-only, for example, the securities may be structured as a Pass-through or a tranches in a Collateralized Mortgage Obligation, CMO. At the point of purchase of the principal-only securities, the would-be holders pay an amount that is actually a discounted value from the face value of the security. The whole face value is eventually received through scheduled payments. A noticeable downturn is that the principal-only strip can be super sensitive to interest rates. If a principal-only strip is made alongside (or entirely) as companion tranche (as explained above), the companion or support tranche is referred to as Super PO.[117]

On the flip side, an interest-only security does not have face or par value. Because it is inversely related to the principal-only strip, it is sold also at a discounted, notional price. The notional price is principal balance used to compute the interest due. The calculation is done on the basis of the present value of the expected interest to be received. As a norm, the price is typically expressed as a percentage of the notional principal. In inverse relationship with the principal-only security, also means that as the notional principal price 'amortizes and repays' the interest-only strip cash flow reduces. This inverse relationship with the principal-only security, turns out to be a special feature that distinguishes the interest-only mortgage backed security as one of the few securities that increases as the interest rate exposure increases. Another benefit, in terms of the features, of the interest-only mortgage-backed security include over-par returns and high yields. This can also turn out to be a demerit in that the hype sensitivity to volatility of the interest rate may work against the investor. This shows that the interest-only mortgage-backed securities can be very risky.

The residual tranches, the name indicates, implies that tranches that are mops the remaining cash flow from the underlying mortgage after when every other obligations have been met. The feature of this tranche makes it to be the last on the collection of cash flow. As an advantage, it is flexible and can be structured in virtually in form – as a PAC or any other sequential arrangement. It is also considered as different on the basis of its tax consideration and characteristics. Floating-rate tranches, as a mortgage-backed security, on the other hand are those that have their interest rate tied to an interest-rate index[118]. It is not unusual to have many securities (by extension major financial instruments)

[117] The Bond Market Association (1999)

[118] Interest rate index is typically an index that is connected to the interest rate of a combined set of a defined financial instrument. As an index, it is determined by the aggregate performance of the individual instrument making up the set. So, it is more or less like a basket of financial instrument with the underlying interest rate determined together as a set. There are however exception to the rule

have their interest rate based on an index. In determining mortgage-based assets' interest rate, an adjustable rate[119] may be tied to the interest rate of the underlying mortgage. Common interest rate index is the LIBOR[120]. Thus for the floating rate tranches, they have interest rate that are tied to the fluctuations of interest rate index, such as the LIBOR. It is also possible to have predetermined limit or extent to which the tie to the interest rate index can reach. For example, there could be a defined 'cap' or 'floor', upper and the lower limits, respectively, that a floating rate tranche can be tied. It is equally possible to structure the floating rate tranche as a TAC or PAC.

3.2 Non Mortgage-Backed Securities

The major difference between the mortgage-backed and nonmortgage-backed securities is the underlying asset. As their respective names suggest, in the former, the underlying asset is tied to a mortgage, while in the latter, the underlying asset can be just anything, aside a mortgage. The non-mortgage backed securities can also be exactly structured as the mortgage-back. The illustrated types of the mortgage-backed securitization explained above – from the most basic and simple pass-throughs to deeply complicated arrangements of pay-throughs. It equally employs range of flexibilities and possibilities, along the desired pattern of investors' risks, returns and maturities. However, the common feature in the classification of the non-mortgage-backed ABS is based on how the pooled resources are issued and how interests on the structured fund are generated. The issuance structure varies, considerably, in-line with the intent of the securitization and the risks tastes of the targeted investors. The issuance structure and the generated interest can be categorized broadly in the way they are amortized or revolved. This slightly differentiates the non-mortgage-backed ABS from the mortgage-backed explained above.

On the one hand, the amortizing and non-amortizing asset is closely related to how mortgage-backed securitizations works. In actual fact residential mortgages are prime examples of amortization of assets. The amortization is the one that needs to be paid off within a scheduled period of time. These payments are usually structured to include the original principal and the accruing interests. The non-amortizing assets, on the flip side, are those that do not have strict scheduled period of the repayment arrangement. They are usually structured in the way that the payments can be revolving. Prime

where an index can be based on a single item – say for example the yield on the U.S Treasury securities.

[119] Usually called the ARM – Adjustable rate of Mortgage.

[120] The LIBOR is an acronym for the London Inter Bank Offered Rate. The World most used index for interest rates, particularly on a short-term basis.

example is revolving credit card account, where scheduled (or preplanned repayment, as the case may be) are not necessarily required but a regular payment that are calculated based on an accrued interest and principal balance.

On the other hand, the issuance structures of the pooled resources can be categorized according to the ability for amortization of the process. For example securitizations that are structured in a way that the proceeds or the principal are returned to the investors for throughout the maturity period of the security is particularly amortizing and spread throughout the period of the life of the security the investors receive returns. To make this obligation of making return to investors feasible, it is not unusual that a conscious calculation is made to make the cash flow from the underlying asset to match the payment stream required and due to the investors. Alternatively, the structure can be made to have similar payment stream and maturity with the underlying asset in a bid to be able to meet the returns obligation to the investors. Either way, obligations throughout the life of the asset is guaranteed the investors. A noticeable drawback is the prepayment risk associated with this non mortgage-backed ABS. The common used structures are Pass Throughs, and Pay Throughs – which can be customized.

As with the mortgage-backed asset, the pass-through in non-mortgage-backed asset securitization is the basic, commonly used. In this issuance structure, the returns to the investors are proportionate and comparable to the allocation of their investments – comprising the principal and interests – just as the proceeds are from the streams from the underlying security throughout the lifetime of the securitization. This means that as the underlying assets cash flow are produced, the correspondingly proportional amount is given to the investors throughout the lifetime of the asset. This principles is transferred and applied to all pass-throughs of non mortgage-backed securitization, even if there are multiple tranches involved in the structure. Where that are multiple tranches, for example, there is actual pro-ration that is done to arrive at a proportional allocation of the proceeds from the underlying instrument to the respective investors.

As with the pay-throughs, the non mortgage-backed securitization can also be arranged to have sequential pay-through structures. This is possible to make them custom-made to accommodate the differences in the tastes of maturities and cash-flow generation. On either side of the adopted style – pay-through or pass-through - the interest accruable can either be floating or fixed. As a noticeable trend in European securitizations and European investors' taste[121] show, non mortgage-backed

[121] The authors and editors of (The Bond Market Association. European Securitization: A Resource Guide. European Securitization Forum, New York) describe this distinguishing feature with European securitization investors.

securitizations in Europe tend to be skewed towards having a floating rate (instead of fixed interest rate). This is particularly so because of the need to have assets and financial instruments tied to a reference interest rate benchmark[122].

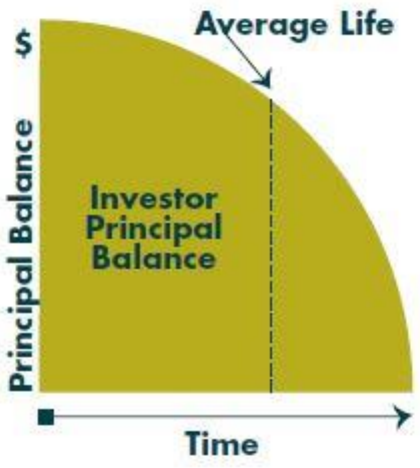
In addition to the possibility for the choice of the floating interest rate over fixed rates, when a fixed interest rate is used, the possibility of having a mismatch of the cash-flow from the underlying assets and the required outcome is appreciably heightened. Thus, to avoid a possible mismatch or varied outcome from the interest rate obligation of the underlying asset and what is expected to generate, a floating interest rate is thus preferred. It is worthy of note, however, that the choice of a particular interest rate regime over another (and the possible attendant problems it could raise) can be easily be solved. For instance, the problem of mismatch of the generated cash-flow from the underlying asset and the desired outcomes can be worked-out by the issuer and the counterparty, by having an arrangement of (for illustration), an interest rate swap.

There are many innovative ways to structure non mortgage-backed assets. For the revolving assets – prime examples include credit cards and trade receivables, leases and consumer debts – securitization is done via a controlled amortization structure. The idea is to match the assets' characteristics with the payment structure. Thus, the payment system of the controlled amortization structure is such that the nature of the underlying assets is ignored. For example, although an underlying asset can be non-amortizing in nature, the payment arrangement could be done in such a way that a predictable amount and repayment schedule is made to the investors from the outset. The issuance structure is so-called as revolving because a 'revolving period' is given, which is primarily predetermined. '' After a predetermined "revolving" period, during which only interest payments are made, these securities call for the return of principal to investors in a series of defined, periodic payments over a specified time frame, usually less than a year''[123]

[122] It is typically done by adding a margin of profit from the LIBOR rate. This is totally relatable for me. I am quite aware from my personal transactions with credit card accounts system and financial institutions in Finland, at least, that floating rates are used. After the use of LIBOR as the reference rate (presumably for its well acceptance in Europe and, perhaps, for the sentiment of the being European), additional margin is added.

[123]The Bond Market Association (1999)

AMORTIZING ABS



- Amortizing structures pay principal to investors in monthly or quarterly installments as received from obligors.

  Interest at a fixed or floating rate is paid on the declining balance.

- Amortizing structures are priced and traded based on average life, which can be thought of as the time-weighted number of months (or years) that principal is outstanding.

- Average life incorporates assumptions regarding prepayments, since any prepaying principal (including losses) will accelerate the rate at which the investor balance is paid down.

- Residential and commercial mortgages, retail auto loans, home equity loans, manufactured-housing loans, equipment loans, and student loans are typically securitised using amortizing structures.

Figure 5: Amortizing Asset-Backed (non mortgage) Securitization payment and issuance structure with some of the major characteristics. Source: *European Securitization: A Resource Guide. European Securitization Forum*, *New York*

Another structure, apart from revolving, is ‘’bullet[124]’’. This is so-called because the intent of the structure is to return principal payment to the investors in one-off, single payment pattern. This can also be used in a revolving arrangement, too.

[124] ‘’ “Bullet” structures, which are also used with revolving assets, are designed to return principal to investors in a single payment. These ABS also feature two separate cash-flow management periods: the revolving period, during which any principal repaid is used to purchase more receivables, which are added to the asset pool, and the accumulation period (analogous to the amortization period in a controlled amortization structure), during which principal payments build up in a separate account to fund the bullet payment to investors. The most common bullet structure is the “soft” bullet, so labeled because the bullet payment is not guaranteed on the expected maturity date (although most such ABS do in fact return principal on this date). In contrast, a “hard” bullet structure ensures that principal is paid off on the scheduled maturity date. This is accomplished by providing for a longer accumulation period, a third-party guarantee, or both’’ - The Bond Market Association. European Securitization: A Resource Guide. European Securitization Forum, New York, page 14

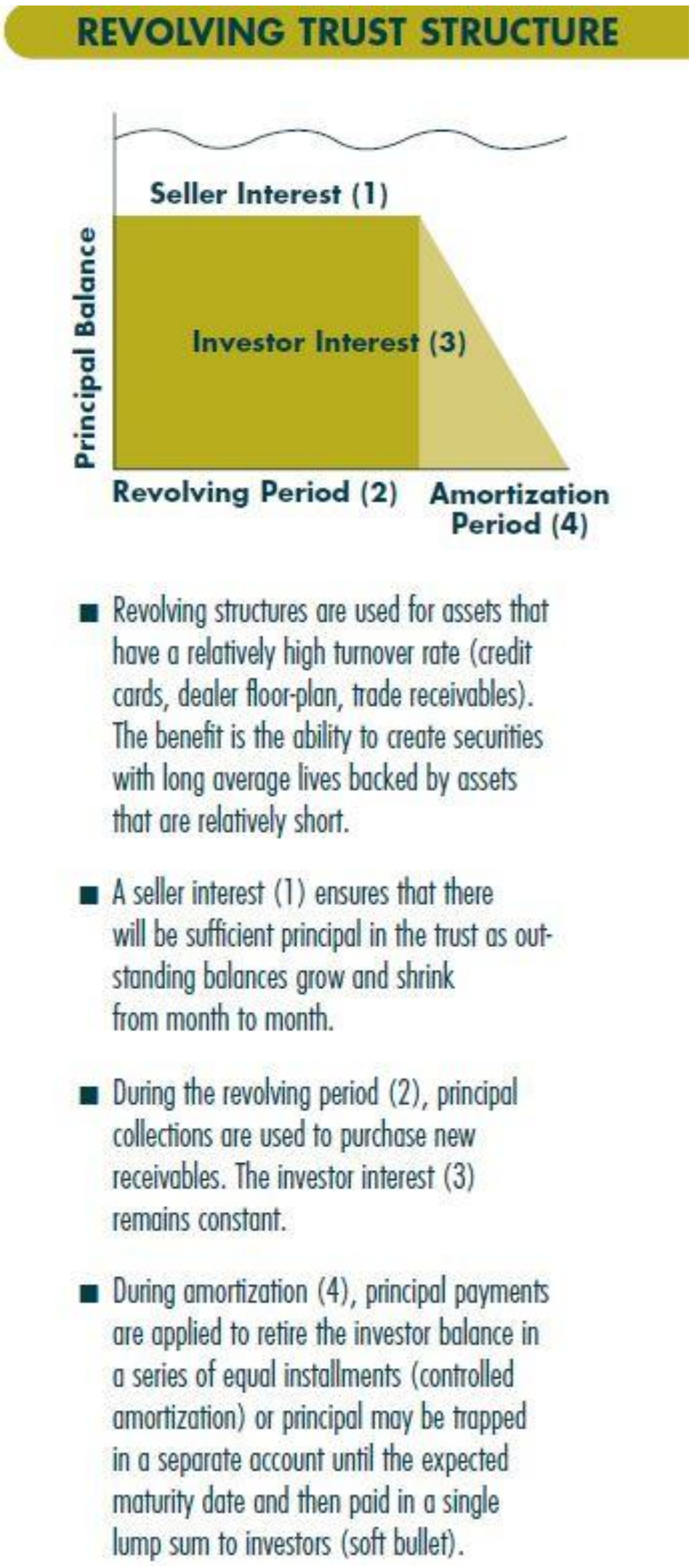


Figure 6: The ‘’Revolving’’ issuance and payment structure with some of the major characteristics.
Source: *European Securitization: A Resource Guide. European Securitization Forum, New York*

Other Securitization Transactions and Structures

Whereas mortgage-backed and non mortgage-backed asset securitizations are somewhat the common ones, there are other securitization structures and transactions, especially Collateralized Loan Obligations, CLO and Collateralized Bond Obligations, CBO. The CLO is a loan arrangement, at best, but used as a security (particularly by banks) and as the name suggests, collateralized by commercial bank loans. It can also assume deeply complicated securitization pattern described above with multiple layers of intertwined obligations and counterparties. In some advanced, complex transactions of CLO, multiple classes of debts are pooled, and the complexity can be notched higher with inclusion of equity. As explained in the opening introduction, the securitization is used through the instrumentality of the SPV – Special Purpose Vehicle. Through this medium, the commercial bank loans pooled is then refinanced and offered to various investors, especially at the international Capital Market and, for example, institutional investors. The Collateralized Bond Obligation, CBO, works almost as exactly as the CLO, only that the underlying assets in the former are corporate bonds, credit-linked notes, and similar debt securities while the latter uses commercial bank loans. Depending on the level of complexity and the layers of counterparties, the underlying assets may not be purely a single form of asset. It could be a mixture or hybrid of assets, unsecured and secured assets pooled together.

The Structuring Process

Securitization are structured differently, in consideration to the investment tastes of desired investors, risk profile and security maturity tolerance of the investors. Typically, securitizations are structured along the major division of the True Sale (also common referred to as the conventional securitization) and the Synthetic securitization. The former implies the use of assets with appreciable degree of similar traits. For example, when assets that have comparable envisaged cash flows are pooled together and used as the basis of the securitization. It is this pooled assets that are transferred to the SPV[125]. At the point of transfer to the SPV, the original remains bankruptcy remote. It can be a double edge stance – as the bankruptcy remoteness of the originator can be either beneficial or disastrous outcome. At best, it affords the originator to be able to exempted from documenting the exposure and risks, as he now enjoys the ‘’off balance sheet’’ treatment. On the flip, it can engender reckless and deliberate irresponsible transfer of toxic assets.

[125] Typically, the SPV that buys over the pooled assets are bankruptcy remote to the originator and the investor. Thus the SPV undertakes the ownership and the risk associated.

There are number of factors that should be met before a true sale securitization can hold. Because there is going to be risk isolation and essentially the originator is going to be bankruptcy remote to the SPV, the conditions and factors are compulsory, regardless of the transaction structure and the legal arrangement of the SPV. The conditions are *non-fraudulent transfer, true sale/non-notification, no commingling risk (First perfected security interest), Bankruptcy-remote (Non-Consolidation), True sale (Non-Limited Recourse).* These conditions mean that the finance activities need to be unquestionably fraud-free in retrospect, and in addition, the assignment must be valid legally. In addition, should there be bankruptcy, the contractual timing of the transactions are sacrosanct, to the extent that the time lines of the transaction is unaffected, as the SPV is seen as seen entirely independent from the originator with little or no recourse[126] rights attached to the originator.

The synthetic securitization on the other hand is designed for mitigating credit risks. Take for example, credit derivatives, credit swaps, credit-links notes *etc* can be securitized with the intent of hedging the attendant risks by the originator. The primary distinction of *true sale* and the *synthetic* securitization is the fact that while in the former, ownership and the attendant risks are transferred altogether to the SPV, in the latter, only the risks are transferred. There are many concerns about the use of synthetic securitizations, but the chief seem to be the relative ease at which synthetic securitizations allow credits institutions, particularly banks, to transfer risks connected to quality assets at the same time remaining exposed to those higher risks.[127]

[126] The Principle of limited recourse emphasizes the loan arrangement where the lender has reduced, limited (and sometimes, no claim) against the parent company if the collateral can't offset the debt repayment.

[127] Basel Committee on Banking Supervision, Working Paper on the Treatment of Asset Securitizations, Oct 2001, Bank for International Settlement.

4. Securitization: EU legal provision before and after the Financial Crisis

Before the unveiling of the STS proposal[128] by the European Parliament and Council, body of law dealing with the securitization cuts across major financial regulation such as banking, insurance, asset management, credit ratings, prospectus and allied financial matters[129]. For banking, the provisions entail prudential measures, risks transfer as well as its management and retention, due diligence and disclosure.

The summary of banking legal acts include regulation 575/2013/EU, the Commission Delegated Regulation 2015/162, the Commission Delegated regulation 625/2014, and the Commission Implementing regulation 602/2014.[130] The first, Regulation 575/2013/EU relates to Capital Requirements Regulation which essentially outlines the prudential requirements for credit institutions and investment firms. It is an amendment to a previous regulation (648/2012/EU). Regulation 575/2013/EU itself has been amended in the autumn of 2014 with the Commission Delegated Regulation 2015/62 which dwells on the application of leverage ratios. Prior to the amendment of Regulation 575/2013/EU in the autumn of 2014, there was a supplementing Regulation in the spring of 2014. The regulation supplemented Regulation 575/2013/EU by focusing on the technical standards and requirements for major parties in banking transactions dealing with securitized deals – the investors, lenders, originators etc. This is known as the Commission Delegated Regulation 625/2014. Lastly, in the summer of 2014, the Commission Implementing Regulation 602/2014 spells out the applying technical standards for the measurement of risk weights in the initial Regulation 575/2013/EU.

[128] Proposal for a Regulation of the European Parliament and of the Council Laying Down Common Rules on Securitization and Creating a European Framework for Simple, Transparent and Standardized Securitization and Amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, COM (2015) 472

[129] Schwarcz (2016)
‘’ The existing regulatory framework governing EU securitization is a hodge-podge that includes the Capital Requirements Regulation for banks, the Solvency II Directive for insurers, the UCITS and AIFMD directives for asset managers, legal provisions on information disclosure and transparency laid down in the Credit Rating Agency Regulation and in the Prospectus Directive, and other provisions on the prudential treatment of securitization in Commission legislative proposals such as the Bank Structural Reform and Money Market Funds. Id. at 4. ’’ - Schwarcz (2016)

[130] The European Commission, Banking and Finance. Accessed on the 25th September, 2015. http://ec.europa.eu/finance/securities/securitisation/index_en.htm

To be sure, the Capital Requirements came into force at the beginning of 2014. It is presently referred to as the Capital Requirement Regulation/Directive (CRD 1V). As the name implies, it is a package that comprises Regulation and Directive, being the third set of amendments to the original Capital Requirement Directives (2006/48 and 2006/49). Thus, at the end of 2013 previous Directives were repealed (CRD I, II. III). As presently, constituted, CRD IV/CRR comprises of Regulatory Technical Standards, Implementing Technical Standards, Commission Delegated Acts, and Commission Implementing Acts. The relevant portion of the CRR that relates to securitization starts essentially from Article 242. The portion treats recognition of significant risk transfer in a traditional and synthetic securitization scenarios, and how the risk weights and exposure values are calculated. From January 2019, Regulation (EU) 2017/2401 will be the latest regulation dealing with prudential matters and Capital requirement, acting as a first leg in the securitization regulation.

4.1 European policy response to the securitization after the financial crisis

There were many measures taken after the financial crisis to curb a possible future reoccurrence in Europe. To start with, there are evidences of large volumes of regulations in and outside Europe that if implemented could have averted the crisis (or at least reduce its impact). For example in the United States, with already two historic crises – the Great Depression and the Savings and Loan Crisis – there already body of legislations that could possibly forestalled the financial crisis fueled by the mortgage crisis[131]. Europe also has fully developed body of financial regulations that could possibly forestall the crisis, or its effects. In effect, regardless of the body of regulation already in place, there were regulatory and policy response after financial crisis, the world over. The sum of the regulatory response to securitization can be classified into five different categories – the need to increase disclosure, risk-retention requirement, revamping the rating agencies, due diligence requirement[132].

Major EU agencies are involved in the policy responses to securitization. For example, the European Parliament and Council and the Financial Stability Board. The crux of the regulatory response is to incentivize people to participate more in securitization, especially opening up the process to be simpler and transparent. Whilst the European Parliament and Council proposed the framework that eventually culminates to the Regulation (EU) 2017/2402 (which is central to this thesis and explained in details later in this thesis), the FSB – Financial Stability Board – developed a dual-step approach. First, it strengthened the monitoring framework that allows national authorities to easily detect (and

[131] Smith, S (2010)
[132] Schwarcz (2016)

apply corrective measures, where necessary) systemic risks pilling up, entrench transparency required. Secondly, it encouraged national authorities to support the execution of the strategy to achieve quick recovery of the effects of the financial crisis and the improvement of securitization in the continent.[133]

The overall interventions (in form of regulations) and initiatives are multifaceted. There are number of public sector schemes and programs, transparency and information sharing initiatives, and as well as private sector driven pan-European and national initiatives. Some of the regulations include Risk Retention Rule[134], EU Credit Rating Agency legislation[135] and general initiatives that foster transparency of information.

With varying degree of aims and objectives, and the duration for the full implementation, the regulatory initiatives work together and they have strong elements in the Regulation (EU) 2017/2402. First, the Retention principles aim to synchronize the incentives of all parties to the securitization deal, predominantly issuers and investors. This regulation aims that, in Europe, 5% retention requirement must be achieved by banks before investing in securitization. It was in force in 2011 and a Binding Technical Standards set for 2015 summer. Eventually, when Regulation (EU) 2017/2402 is fully developed, retention is one of the key component introduced.

Second, the BCBS Capital and Liquidity requirements[136] intend to correct the misalignments in the securitization market, bothering on robotic overreliance on credit rating agencies' judgements, and low risk downgrades. It also promotes the elasticity of the liquidity risk profile, albeit on short-term basis. The former, pertaining to the Capital, requires banks to have enough capital against investments in securitizations and the consultation closed at the spring of 2015; while the latter, pertaining to liquidity, requires banks' liquidity assets to be higher than the estimated net cash outflows over a period of 30 days.[137]

Third, Solvency II directed specifically at insurance companies. It intends to shore up the capital requirements for the insurers so as to be able to improve the quality of insurance protection to the securitization active market participants and players. Lastly, Consolidation and Sponsorship. This

[133] ECB and BOE (2014)
[134] Originators are expected to maintain some ''skin-in-the-game''
[135] This upgrades the openness of the operations of the rating agencies.
[136] BCBS means the Basel Committee on Banking Supervision.
[137] ECB and BOE (2014)

aims at striking a positive balance between the risks exposure of banks' off balance sheet items and securitization vehicles.[138]

4.2 Reservations about the policy response

Despite the regulatory interventions, the current state of the European securitization market is still passive and yet to regain full recovery of the impact of the financial crisis. The issuance of securitization peaked at the start of the financial crisis with over 800 Billion euros, the following years as the impact of crisis took its toll, the volume of the issuance in Europe markedly decline. As can be seen from the figures below, from 2009 downwards, the issuance at best is about half of the issuance level when it's peaked, and at worst, in the first quarter of 2017, is less than 15% of the issuance level of 2008. Interestingly, the contrast is the case in the United States[139]. Just as the level of issuance significantly dropped, the percentage of the securitization vehicles' placement and retention markedly also changed.[140]

Therefore, the impact of financial crisis on securitization in Europe is still enormous. Some of the reasons for remarkably negative impact include the fact that the confidence and trust in securitization is doubtful[141]. One possible way to increase the faith in the European securitization is to borrow a cue from the United States, where incentives like government-backed guarantees can be proposed to investors. This can be collectively done – involving the major parties in securitization, the European Central bank, national government *etc* – and the role played in the United States by Fannie Mae and Freddy Mac can be replicated in Europe. Another plausible reason for slow recovery of securitization is the relative dearth of tailored-made securitization transaction for European investors. By this, I

[138] ECB and BOE – The case for a better functioning securitization market in the European Union, May 2014 Euro System

[139] Deloitte (2018)
'This stands in contrast to US issuance which has recovered more strongly. One factor that has led to the US market not to experience such a steep decline in issuance is the role that US government-sponsored enterprises (eg Fannie Mae and Freddy Mac) play. The EU estimates that around 80 percent of all US securitization benefit from public guarantees and banks investing in such securitizations benefit from lower capital charges.'

[140] Deloitte (2018)
'Prior to 2007, most securitization vehicles were placed, but following the financial crisis, issuers have retained the majority of European issuance.''

[141] Regardless of the planned and executed interventions of the European Union policy makers, and the fact that the very low default rate of triple A and triple B rates of the EU securitization vehicles during the financial crisis.

mean there could be specialized securitization that take into account the peculiarities of the parties. For example, in the case of loan securitization, the distinct positions of the issuer, originator, and borrower can be considered. The SME true-sale loan securitization is a classic example of how the objectives and requirements of investor, borrower, sponsor, originator and issuer can quite different.[142]

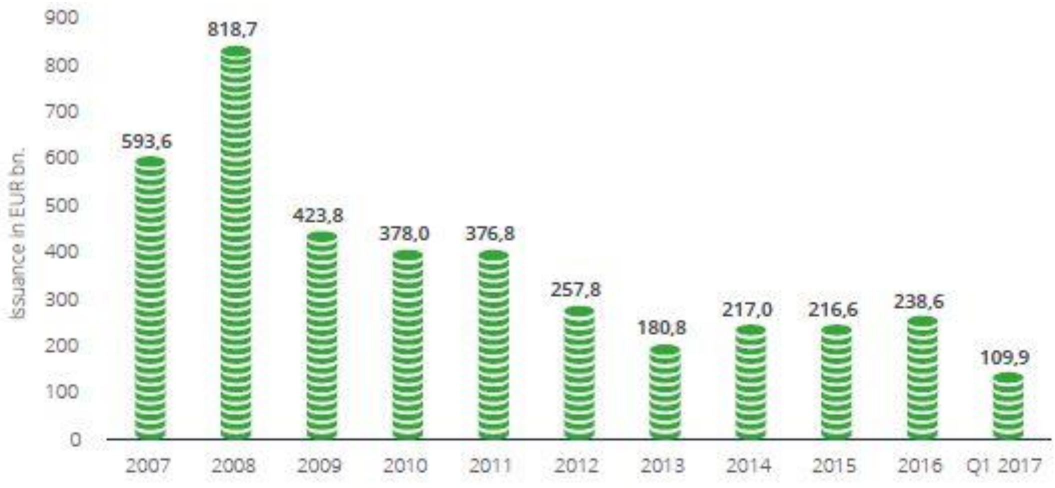


Figure 7: European historical issuance 2007 to 2017 Q1 (in EUR billion)
Source: Deloitte (2018)

Figure 8: European historical issuance 2007 to 2017 Q1 (in EUR billion)

[142] Deloitte (2018)

On their part, both the European Central Bank and Bank of England allege that the current impaired state of the securitization market in Europe is caused by 'misalignments'. These misalignments are somewhat deeply ingrained that the sum of the interventions so far are yet to produce the desired improvement of the securitization market in Europe. Thus, presently, there are still obstacles in the securitization market of Europe. This is as a result of relatively alternative cheaper source of funds, overall macroeconomic struggles of many European countries, declining demand for loans, inconsistent and ununiformed regulatory frameworks across the jurisdictions, and valid concerns about the dwindling price qualities of underlying assets for the securitization pool.[143] Hope with Regulations 2017/2401 and 2017/2402 coming into force in 2019, there will be increase and confidence in European securitization.

[143] ECB and BOE (2014)

5. Regulation (EU) 2017/2402

The Regulation (EU) 2017/2402 is a regulation of the European Parliament and of the Council that creates the general framework for securitization and creating specific framework for simple, transparent and standardized (STS) securitization, and amending Directives 209/65EC, 2009138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and EU No 648/2012. It is a product of a rigorous, painstaking, and long process of strengthening the securitization process in Europe. Till date, it is the most detailed and far-reaching regulation on securitization in Europe. It emphasizes the STS label for securitization transactions that are simple, transparent, and standardized, that will make them (such STS-labelled transactions) qualify for better prudential treatment.[144] On the one hand, the regulation repeals and amends existing Directives and legislative instruments overseeing European securitization, and, on the other hand, provides clear guidelines on general and specific securitization measures in Europe. It was officially published in the Official Journal of the European Union by December 2017, and expects to be in force, Europe-wide, by January of 2019. It is arrived at after due consultations and follow-up on proposals[145], engagements[146], and opinions of relevant stakeholders.

Previously, at the regional level, there have been concerted effort to correct the outcome of the role securitization played in the global financial crisis of 2008. Amidst other regulatory and systemic approaches in combating the aftermath of the financial crisis, the Commission, at the end of 2014, announced its intention to make available workable and trusted securitization markets. The promise of the revamped securitization market is expected to be a high-quality, trusted securitization market with sufficient transparency, simplicity, and harmonization across the region. Thus the Regulation 2017/2402 is for financial and credit institutions that operate essentially with securitization. It lays down the general and specific frameworks for the operation of securitization.

Secondarily, the regulation recognizes the place of securitization in the European economy – its large economic benefits, particularly the allocation and diversification of risks in the financial system of the EU – and the attendant possible damage, if misused.

[144] EBA Consultation paper on the STS criteria for non-ABCP securitization. It is hoped that the differential capital requirement for the STS-tagged transaction will be sufficient motivation for securitizes in Europe to fulfil the criteria of having the STS.

[145] One of such proposals is the opinion of the European Central Bank of OJ C 219, 17.6.2016, p. 2.

[146] The European Economic and Social Committee is also engaged and opinion sought before the eventual publication for the Regulation, OJ C 82, 3.3.2016, p. 1.

To this end, the Regulation (EU) 2017/2402 sets out to mitigate the risks of the increased interconnectedness and the excessive leverage that securitization uses. In similar dimension, the Regulation 2017/2401 hopes to strengthen the microprudential supervision of the relevant competent authorities within the EU that will qualify as the criteria in participating in the securitization market in Europe[147]. In the end, it is expected to enhance efficiency in the financial system, upgrade the trust for the sanctity of the market while enjoying the economic benefits derivable from securitization.

5.1 The structure of the Regulation

The Regulation (EU) 2017/2402 concerns the general guidelines and the specific framework for securitization. Those two – the general guidelines and specific framework – form the basic division of the Regulation (EU) 2017/2402. The general part involves, primarily, credit risks and tranching. The specific framework part relates to having a 'simple, transparent and standardized (STS) securitization. The Regulation (EU) 2017/2402 uses a broad definition of the word 'securitization' because it contextualizes the term, loosely, to describe transactions and schemes where credit risks can be tranched.

The Regulation (EU) 2017/2402 applies to major stakeholders in the securitization market in Europe – the institutional investors[148], originators, securitization special purpose entities (SSPE), sponsors, and original lenders. These stakeholders have varying definition by the Regulation (EU) 2017/2402, especially based on the degree of commitment, and interrelationships of the firms in the securitization market. For example, by the Regulation (EU) 2017/2402, the role of a sponsor is somewhat restricted, and it is limited to credit institutions and investment companies. Furthermore, a sponsor is able to delegate roles and tasks to servicer, but a sponsor remains the ones responsible for the risk management, where the servicer himself is a regulated asset manager.[149] In addition, there is supposed to be alignment in the interests of the stakeholders, by making sure that the original lender or the sponsor retains the greater part or significant part of the underlying exposure of the securitization risks.[150]

[147] L 347/35/regulation (EU) 2017/2402
[148] The Regulation (EU) 2017/2402 also broadly uses the term institutional investor to cover of finance professionals and companies like insurance or reinsurance entities, institution for occupational retirement provision, the AIFM – Alternative investment fund manager, any company for the collective investment in transferable securities (UCITS - especially if internally managed), credit institution and investment companies.
[149] Regulation (EU) 2017/2402, para 7
[150] *Ibid*, para10

Interestingly, as a major landmark feature of the Regulation (EU) 2017/2402, re-securitization is essentially prohibited[151]. The prime reason for the ban is the aid of re-securitization to opaque nature of re-securitization transaction. The drafters of the Regulation (EU) 2017/2402 believe that re-securitization decreases the level of transparency that Regulation (EU) 2017/2402 seeks. There are however increased chances of derogation of the ban on re-securitization, where legit, transparent transaction is known, or where (or pending) on the (re)classification of ABCP[152] as resecuritization[153]. The ban can also be relaxed under 'exceptional circumstances' where the resecuritization is in the interest of the investors, or where the real economy, via the ABCP programmes, is to benefit. This ban starts from when the Regulation (EU) 2017/2402 enters into force, hence it does not affect securitizations before 2019 and securitizations that are for legitimate[154] purposes.

A securitization transaction, as per the Regulation (EU) 2017/2402, is not expected to constitute a specialized lending to finance or operate physical assets. So, the Regulation 2017/2402 is aimed at streamlining the legislative framework on securitization, and at the same time merge all present sectoral legislations on securitization into a single, comprehensive whole.[155]

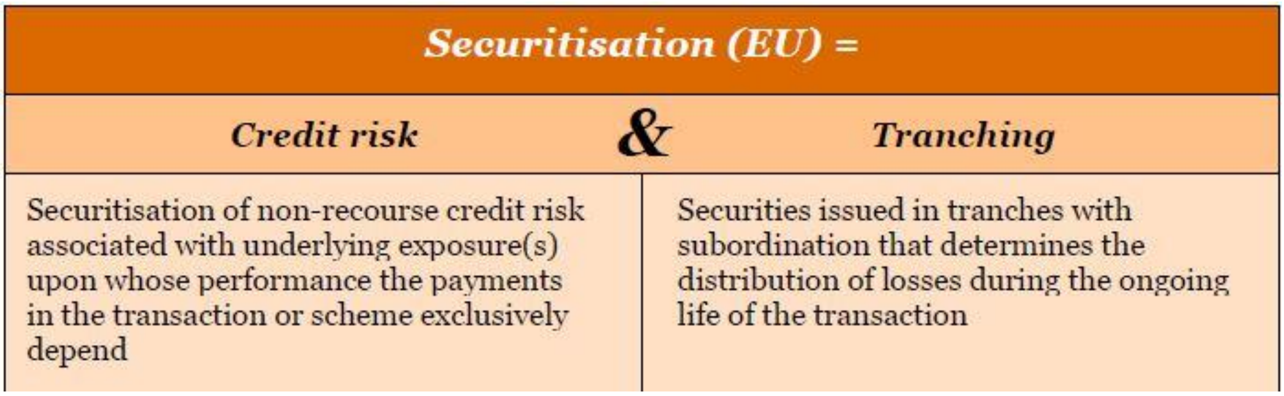


Figure 8: The classification of the Regulation and the definition. Source: PricewaterhouseCoopers, Société cooperative (Luxemburg, 2018)

[151] Para 8 of the article emphasizes the ban on re-securitization. There are exceptions, however, where there are legit claims of the usefulness of the securitization, referred to as 'exceptional circumstances'.
[152] ABCP means Asset-backed commercial paper.
[153] Para 8
[154] The definition of legitimate purposes are listed in the para 3, of article 8 of the Regulation 2017/2402 to include facilitation of winding-up of a credit institution, a financial institution, or an investment company, ensuring the viability of as a going concern of a credit institution, an investment firm or a financial institution in order to avoid its winding-up and where the underlying exposures are non-performing, he preservation of the interest of investors.
[155] 2018 PricewaterhouseCoopers, Société coopérative, New EU Securitization Regulation: Impact on Luxemburg structures, 2018

5.1.1 General Framework

The general framework part of the Regulation occupies the second chapter of the Regulation (EU) 2017/2402. It spans, primarily across articles 5 to 7 with the main themes of due diligence, risk retention, and transparency.

i) Due Diligence

As part of its due diligence, the Regulation (EU) 2017/2402 requires institutional investors (other than the original lender, the sponsor or the originator) to verify certain components of the securitization transaction, prior to holding a securitization position. The crucial elements include the credit-granting process of the originator[156], the adherence and compliance of the originator to risk retention requirements, regular provision of required information by the originator, and the risk characteristic and structural traits that are to be in accordance to written processes, both to be initially written and those to be added on ongoing basis. If the originator or the original lender is not a firm established in the European Union, the due diligence is perhaps more pronounced as the credit-granting process needs to be in compliance with 'sound and well-defined criteria' of creditworthiness, and effective credit financing systems. If on the other hand, the originator is established in the European Union, then the originator is obliged to disclose material information on the risk retention level on a continuous basis.

The due diligence of the institutional investor extends to the thorough assessment of the risk profile of the securitization positions to be held, regardless if such securitizations are supported with the ABCP Programme or otherwise, particularly as it affects the underlying exposures – its 'types, the percentage of loans past agreed due dates, default rates, payment rates, loans in foreclosures, recovery rates, repurchases, loan modifications, payment holidays, collateral type and occupancy, and frequency distribution of credit scores or other measures of creditworthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with bands widths that facilitate adequate sensitivity analysis'. It could also be that the underlying exposures themselves are securitization, and in that case, the institutional investor can extend its due diligence to those underlying exposures[157]. The due diligence equally extends to the assessment of the institutional investor in ascertaining the structural features of the securitization that can significantly affect the performance of the securitization position – the contractual priorities and

[156] Particularly so, if such credit granting firm is not established in the European Union.
[157] Article 5, para 4(a)

frequency of payments and priority of payment-related triggers, credit enhancements, liquidity enhancement, market value triggers, and the transaction-specific definitions of default[158]. The due diligence requirement of the institutional investor, to my mind, is an encouraging, novel addition of the Regulation 2017/2402. The financial crisis had such devastating effect on the global financial system because of lack of some of the fine-details the due diligence now requires. Of course, it can be viewed as additional burden on the part of the institutional investors, but at the end of the day, the due diligence requirement increases the safety net for eventual down-turn that can ensue in securitization transactions.

ii) Risk Retention

The Regulation expects the interests of the originator, the original lender or the sponsor align with those of the institutional investor. To therefore attain this, the Sponsor, Originator, or the Original Lender is expected to retain significant net economic interest in the securitization on an ongoing basis. The net material economic interest is not expected to be less than 5% of the notional value of the origination, for off-balance sheet items. Of course, to reflect the true state of the value, the net economic interest is not supposed to be subject to hedging, or any credit-risk mitigation. Furthermore, it is only one party that is expected to have the risk retention. In the event that it turns out that there is no agreement on the basis for risk retention, the originator then is obligated to fulfil all the risk retention requirement. That way, there would not be a split that could potentially reduce the actual risk retention percentage of the net economic interest. In addition, to safeguarding that there is no split, there isn’t supposed to be any multiple applications for the retention requirement. Entities that are created or that operate in securitizing exposures wouldn’t be qualified to be originator. These requirements seem to be clearly thought-out ones by the drafters. In all, it ensures that the net risk retention is appropriately captured.

Risk retention is laudable because there are number of technical procedures that originators can perform to weaken their risk retention profile and eventually transferring the risks to institution investors. In securitization transactions, risk retention can be hugely avoided with many technical procedures – some of which the Regulation frowns out: Split and multiple applications.

With the benefit of hindsight from the financial crisis, one of the prime culprits is the mismatching of subprime assets with prime ones, thereby disproportionally transferring risks of different features to different classes of investors making the process less transparent and complicated. ‘Securitization

[158] Article 5, para 3(b)

resulted in complex, opaque and risky financial products that caused the financial meltdown of 2008'.[159] One of the ways to forestall similar treatment, the Regulation (EU) 2017/2402 prohibits originators from cherry-picking assets to be transferred to SSPE with the intention of 'rendering losses on the assets transferred to the SSPE, measured over the life of the transaction, or over a maximum of 4 years where the life of the transaction is longer than four years, higher than the losses over the same period on comparable assets held on the balance sheet of the originator'.[160] For all the prohibitions of risk retention, there are exceptions. The prohibitions and threshold of percentage of risk retention doesn't apply where, for example, the securitized exposures are 'fully, unconditionally and irrevocably guaranteed by central banks or central governments, regional governments, local authorities, public sector entities, national promotional banks or institutions, and multilateral development banks'.[161]

iii) Transparency

To forestall a reoccurrence of the events of the global financial crisis, there is, in the Regulation (EU) 2017/2402, a higher sense of transparency and information sharing on the part of the originator, Sponsor, SSPE etc to the institutional investors. For starters, the originator, sponsor or the SSPE are obligated to provide the investors (even before concluding or holding the securitization position) on a regular basis with sufficient information that are material for the informed decision of holding the securitization position. The frequency of the information may vary depending on the types and class of the securitization. For example details about the underlying exposures and documentations[162] are vital enough to be provided to the investors, and they are to be provided on a quarterly basis. Fine line and details are not to be left-out, say for example, information about the description of the payment priority. Where an ABCP is concerned, the frequency can be on monthly basis. In addition, the originator, sponsor, and the SSPE have to come to an agreement about who should be designated

[159] Ewald Engelen and Anna Glasmacher (2018)
[160] Article 6 para 2
[161] Article 6 papa 5(a),(b),(e)
[162] Important documentations like the final offering document or the prospectus together with the closing transaction documents, excluding legal opinions, sale agreement assignment, novation or transfer agreement and other relevant declaration of trust, the derivatives and guarantee agreements, as well as any relevant documents on collateralization arrangements where the exposures being securitized remain exposures of the originator; the servicing, back-up servicing, administration and cash management agreements; the trust deed, security deed, agency agreement, account bank agreement, guaranteed investment contract, incorporated terms or master trust framework or master definitions agreement or such legal documentation with equivalent legal value; any relevant inter-creditor agreements, derivatives documentation, subordinated loan agreements, start-up loan agreements and liquidity facility agreements;

to provide all the information. To my mind, it is laudable that there is element of independence and choice of who to provide the information, however, I do believe that it is of a greater concern to the investors' interest if the Regulation (EU) 2017/2402 states categorically who amongst the parties would be responsible for what information. I hold this opinion because the roles of the parties in securitization transaction is defined and clear. The designation of information sharing should carry increased importance, in my opinion.

The additional laudable feat of the Regulation (EU) 2017/2402 is the almost compact, and comprehensive nature the provision of the relevant information is expected to be. There are substitutes and alternatives for originator, SSPE, and sponsor that may want to exploit loopholes in their status. For example, there is the demand for alternative information if, for instance, a prospectus has not been drawn. In such situation, transaction summary[163] and reports are demanded[164]. Furthermore, the timing of the release of the information is also very critical to its ability to help transparency. It is also commendable that the Regulation envisages how appropriate the timing of the release of the information is.

First, the information about all underlying documentation that is essential for the understanding of the transaction, and the alternative information in the absence of a prospectus are to be given before pricing. While information about the underlying exposures (on a quarterly and/or monthly basis, as the case maybe) are to be provided simultaneously each quarter at the latest one month after the due date for the payment of interest (and in the case of an ABCP transactions) at the latest one month after the end of the period of the concerning report. With these fine-details about timing, frequency and the comprehensive nature of the information that are to be provided to investors, the opaque nature of securitization in Europe is on its way to extinction, barring any other unknown technical procedures that is not covered by this Regulation.

More so, the Regulation (EU) 2017/2402 requires that the originator, sponsor, and SSPE make available the information through a securitization repository. The drafters of the Regulation foresees

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[163] Details of the alternative report and transaction summary should include details regarding the structure of the deal, including the structure diagrams containing an overview of the transaction, the cash flows and the ownership structure; details regarding the exposure characteristics, cash flows, loss waterfall, credit enhancement and liquidity support features; details regarding the voting rights of the holders of a securitization position and their relationship to other secured creditors; a list of all triggers and events referred to in the documents provided in accordance with point (b) that could have a material impact on the performance of the securitization position.

[164] Article 7, para 1(c)

the need to have a single, one-stop-shop where all information about the concerned securitization can be got.

5.1.2 Specific Framework: *STS CLASSIFICATION*

To understand the importance of the STS criteria, background and context is necessary. There are number of reason that would incentivize securitizes can get the STS tag. While Regulation (EU) 2017/2402 gives the substantive rules, Regulation 2017/2401 deals with the prudential securitization and how certain institutional investors can potentially benefit from the STS securitization by giving comparable or corresponding rules for insurers and credit firms, for example. Regulation 2017/2401 deals with the rules on capital requirements. Taken together, both Regulation 2017/2401 and Regulation 2017/2402 are significant measures in improving securitization in Europe. The STS classification becomes necessary to differentiate securitizations that are screened and could be adjudged simple, transparent, and standardized. The securitization market is still impaired, and somewhat suffers from stigma of its association with the financial crisis, when a securitization transaction is tagged STS, it is certification that such transaction is simple, transparent, and standardized. This means that, for example, the risks involved in a particular securitization transaction are assessed and adjudged appropriate. The tag helps all parties in involved in securitizations, especially the investors. With this tag, securitizes get 'pass mark' to operate securitizations that are more or less endorsed, in terms of regulatory certification. Hence, securitizes are motivated to get the STS tag. On the global level, there are coordinated efforts to see that securitizations are structured appropriately. An example of such global effort is the STC criteria by the BSBC-IOSCO[165] taskforce. Merged with the European side, the global securitization market will be the better for it[166].

Snapshot of Regulation 2017/2401

Regulation 2017/2401 is the Prudential Securitization Regulation that replaces the Capital Requirement Regulation. It contains, amongst other things, the prudential treatment and differentiated capital requirements for institutional investors like banks and investment companies how they can probably benefit from favourable regulatory capital treatment for STS securitization exposures. For example, in Article 206 of the Regulation 2017/2401, for securitizations that are STS compliant, there's a special treatment for the risk calculation, i.e. the risk-weight floor for senior securitization

[165] Respectively, the joint effort signifies the work of Basel Committee on Banking Supervision and the Board Of International Organization of Securities Commissions. The scope and a recent press briefing on the joint effort is available at https://www.bis.org/press/p180514.htm
[166] European Commission (2018)

positions is 10%. Furthermore, in article 264 of the same regulation, for STS-tagged securitization positions, there is special treatment for the exposures that are on short and long term basis. This acts as motivation of securitizes to get the STS tag.

So Regulation 2017/2401 amends Regulation (EU) No 575/2013 by inserting, replacing, or deleting appropriate points. For example Article 4(1) is amended by replacing points (13) and (14) with appropriate definition of 'originator' and 'sponsor', and insertion like 'original lender' are made. It equally covers treatment of securitization positions (article 109), definitions and criteria for simple, transparent and standardized securitizations (article 242), criteria for STS securitizations qualifying for differentiated capital treatment (article 243), recognition of significant risk transfer, (article 244) synthetic securitization, operational requirements for early amortization provisions (article 246) and the calculation of risk-weighted exposure amounts. As a whole, it acts as background that seamlessly connect Regulation 2017/2402.

Regulation 2017/2402 Specific Framework for STS classification

The other leg of the Regulation 2017/2402 bothers on specific requirement for securitization transactions that are 'simple, transparent, and standardized. With the specific framework of the Regulation (EU) 2017/2402, it is easier to have a harmonized, and a more risk-sensitive prudential framework across the region, EU-wide. The trio of opaque, complex, and lack of standardization features of securitization played a vital role in the financial crisis, hence the specific framework of the Regulation tackling these tripartite problem is very laudable. In order for a securitization transaction to be classified as a 'simple, transparent, and standardized', it has to pass number of criteria. Predominantly, each of the sub-headings have their areas of specialization. For example, the sub-heading simplicity concerns portfolio and cash flows, while transparency concerns investor data availability, and standardization concerns structural elements. For the tag of STS to apply, the originator, the SSPE need to be domiciled in the European Union jurisdictions.

Simplicity	Transparency	Standardisation
Portfolio and cash flows	**Investor data availability**	**Structural elements**
• True sale only • No active management (eligibility criteria) • Homogeneous asset type • No re-securitisation • No defaulted exposures • Cash flows not substantially dependent on sale of asset • At least one payment made • ...	• Historical (≥5yrs) default and loss performance data • Sample of exposure independently verified • Liability cash flow model linked to exposure • Originator and sponsor responsible for transparency (incl. STS notification and quarterly investor reporting) • ...	• Risk retention satisfied by originator, sponsor original lender • Interest and currency risk mitigated • Roles and responsibilities of transaction parties, esp. servicer, clearly described • Remedies and actions in case of delinquency/default of debtors or conflicts of investors predefined • ...

Figure 7: Summary of the Simple, Transparency, Standardization (STS) criteria. Source: PricewaterhouseCoopers, Société cooperative (Luxemburg, 2018)

It is noteworthy to state that the framework doesn't in itself implies that the STS securitization position is entirely free of risks, or a rubber stamp for prime status for the underlying assets, it shows that a cautious and diligent institutional investor will be in a better position to analyze the risks involved in the securitization. There are at least three classifications of the criteria: the STS criteria, the additional requirements, and the third party verification.

Simplicity

The requirements relating to simplicity demand that the title to the underlying exposures is only to be acquired by the means of true sale, assignment or transfer with the same legal effect in the manner that is enforceable against the seller or any other third. This corresponds to Article 20 of the regulation. This requirement is beneficial on many fronts: it compensates for the lack of simplicity that surrounds the title and responsibilities of SSPE. Now, with this requirement, it means that when a transfer of tittle is effected to the SSPE it will not be subjected to clawback[167] provisions, should

[167] Clawback means a clause that are included in agreements (especially financial agreements) whereby money already paid must be retuned where certain conditions are met. Clawback provisions can come in various forms. According the Regulation, the following will be assumed to the clawback provision: provisions which allow the liquidator of the seller to invalidate the sale of the underlying exposures solely on the basis that it was concluded within a certain period before the declaration of the seller's insolvency, provisions where the SSPE can only prevent the invalidation referred to in point (a) if it can prove that it was not aware of the insolvency of the seller at the time of sale.

there be insolvency of the seller. The essence of this requirement, to my mind, helps clears the ambiguity surrounding the legal entity and the nature of the liability of parties in the transfer of title. It is particularly beneficial in that, in the case where there are many intermediaries between the seller and SSPE (or where there is no direct transfer of title between SSPE and the seller) that the same legal effect is applicable in each of the steps. Understandably the national insolvency laws of member states will play significant role in the adjudication of insolvency, if it happens in in securitization, however, the idea is to create simplicity in the treatment of transfer of title of underlying exposures to show fairness.

In addition, the regulation's specific clauses of *no active portfolio management*, *the homogenous assets types*, *the ban on re-securitization*, *no default exposures*, and *cash flow not substantially dependent on sale of asset*, and *at one payment* make otherwise complex nature of securitization to be simplified. For example, when underlying exposures are transferred from the seller to the SPPE, it is expected to 'meet predetermined, clear and documented eligibility criteria which do not allow for active portfolio management of those exposures on a discretionary'[168], and to be sure, accepted securitization by the Regulation only accepts pool of underlying assets that are of the same features (particularly in the areas of cash flow of the assets, contractual credit-risk and prepayment characteristics), and the underlying exposures are to be contractually binding and enforceable.

Transparency

To open the inner workings of securitization and holding its position, there is need for data to be available for institutional investors to make informed decisions. This requirement is a landmark development compared to the pre-financial crisis era. The Regulation requires historical default and loss performance data, the need to have sample of exposure independently verified, the need to have liability cash flow model to be linked to the concern exposure, the responsibility of the originator and sponsor to make sure that transparency is made by making frequent, regular reports. The requirement makes sure that at least 5 years of data to be made available. The length of time is ideal. Five years seems a reasonably fair time frame that indicate the average performance of a firm – this way exceptional circumstances that could affect the performance of the firm is easily noticed. Apart from the length of time the data should be provided, it should comprehensive – containing the dynamic and static data, and information that the data provide must be similar to assets that are to be securitized. This inclusion is very necessary. Whereas if neither of the type of data is required, odds are that the firm can provide information that is less useful for the potential investor. Static data, by nature, are

[168] Article 20 (7)

fixed, while dynamic are variable. If static data of five years are presently, it will give an inaccurate picture. On the other hand, if dissimilar data that is unconnected to the assets to be securitized is provided, it contribute little or nothing to the sound decision the investor is expected to make. Hence, the comprehensive nature and similarity of the data to be provided is impressive.

Transparency is increased if sample is subject to external verification, or the cash flow model denotes the contractual relationship between the underlying exposures and the payments flowing between the relevant parties – the originator, SSPE, investors, and third – and thereafter made available to the investor on a continues basis.[169] Here, as plausible as the use of an external verification sounds, there are at least two noticeable drawbacks it can bring. First is the 'authenticity' of the report of the external verification. My reservation is premised on the fact of the role rating agencies played in the financial crisis. Of course, 'external verification' can be compromised. Rating agencies tag many sub-prime mortgages as prime before the bubble burst in the financial crisis. With the benefit of hindsight, external verification is good, but the process can be compromised. Second is the transactional costs. It is not clear from the Regulation if the cost of the external verification is borne by the investor or by the originator or the SSPE or even competent national authorities in the member states. Either way, the cost of the external verification is mostly likely factored in the securitization, and likely passed on to the investor.

Standardization

The standardization phase of the STS criteria bothers on structural elements. It requires that the risk retention part of the Regulation must be adhered to by the originator, and sponsor. It expects that the currency risks and interest risks be mitigated. This has multifaceted benefits. On the surface, it helps bring standardization, but, deeply, it goes into the heart of investor protection and transparency. SSPE are particularly prohibited for entering into derivative contracts or transaction, and their pool of underlying exposures are not expected to have derivatives, except for the purpose of hedging interest-rate and currency risk. This requirement seems laudable, but somewhat contradictory. It is fine to have standardized securitization structure (prohibiting derivatives of the underlying exposure), but this could be easily manipulated. Every attempt to make re-securitization from the back door (and in fact, making derivatives of underlying exposures) can be lumped under the exception: ''for currency and interest-rates hedging''. Thus, as laudable as this section of the Regulation is, it can be, to my

[169] Article 22 (2)(3)

mind, easily manipulated. It is good that the interest rate to be referenced should be known and common ones, without complex calculations.

In addition, the tasks and roles of the parties (particularly those of the servicer) involved in the securitization need be clearly described and disclosed. Securitization process also will be a lot more standardized when remedies and actions in case of default of debtors or conflicts of investors are predefined.

Sundry, Addition Requirements

After fulfilling the STS criteria described above, originator, Sponsor, and SSPE must be established in the European Union, and all the STS are to be published in a list on the official website of the ESMA[170], and the originator and Sponsor shall jointly notify ESMA of the new STS securitization and to verify the level of compliance of the STS criteria.

Third party verification

Originator, Sponsor and SSPE may use the service of an authorized third party to check whether a securitization complies with the STS criteria. However, the use of such a service shall not under any circumstances affect the liability of the Originator, Sponsor or SSPE in respect of their legal obligations under the Regulation nor the due-diligence obligations imposed on Institutional Investors.

[170] ESMA is the European Securities and Markets Authority.

6. Major Regulatory and Legal Challenges of Securitization in Europe and Specific Concerns of Regulation (EU) 2017/2402

No doubt, securitization has many benefits. With the Regulation (EU) 2017/2402 coming into force at the beginning of 2019, the landscape of securitization in Europe will take a new, different shape. The events culminating into the financial crisis, especially the agonizing memories of the effects of securitization of sub-prime mortgages, it is understandably hard to envisage the possible gains of securitization. The start and the spread of the sub-prime mortgage crisis, as powered by securitization, to its eventual culmination into full-fledge financial crisis, has witnessed considerable amount of economic downturn. The mortgage originators played a crucial role in the eventual crisis. Main major fault of the mortgage originators is the somewhat sub-par underwriting standards. On the one hand, the mortgage originators were quite aggressive in sourcing potential home buyers (to, understandably, increase the stream of cash flow for the pool), and on the other hand, a weak underwriting standard. With the benefit of hindsight, the reasons for the stance of mortgage originators (without possibly discounting the roles of the rating agencies in rating sub-prime mortgages as prime ones), can at least be three – the pricing dynamics of housing, interest rate mechanism of the Federal Reserve, and the balance sheet effects to the originators.[171]

As seemingly beneficial as securitization is, there are major concerns about the legal and regulatory challenges it brings to bare, especially when it is structured in international or transnational context. The financial crisis demonstrates this fact that the sophistication and how securitization is structured has implication for many branches of law. The immediate implication, most glaringly, is securities law. In addition securitization affects other aspect of law, for examples – tort liability, bankruptcy law, and sundry legal doctrines, for instance, substance-over-form doctrines. This is not creating the impression that these challenges are peculiar to securitization, or that other types of financial innovation do not have challenges, however, securitization displays these challenges in a rather higher magnitude. Notable challenges that can come with cross-border or transnational securitizations include interlaying relationships and the problems of establishing liability, bankruptcy law and its application, its definition as a financial innovation moving towards a legal concept, and its heavy reliance on substance.

[171] Fabozzi, Frank J and Vinod Kothari (2008)

Securitization and Bankruptcy Law

With Securitization as one of the leading forces of financial markets[172] and representing a major form of financing, and with a prospect of doing more in the US market, it is concerning that it seems the law, as they seem to be today, are not overtly equipped for tackle some issues surrounding the use and application of securitization. One area of such concerns in bankruptcy law. Understandably, the idea of the Regulation (EU) 2017/2402 is to somewhat bridge the gap inherent in securitization and law, however, a lot still have to be done. Starting from the very intent of securitization – getting alternative financing means, sort of a low-cost capital, that are not typically available in conventional means – it is to be noted that legal provisions ought to be in the relatively novel form to match the challenges that will be coming from securitizations, a novel but sophisticated financial product, itself.

In addition, securitization is expected to provide a platform that, in the event of the originator's bankruptcy, the stream of payments, i.e receivables, are to be separated from the originator. Thus the SPV plays a vital role in the separation of the originator's estate in the event of bankruptcy. Drawing up the interplay of bankruptcy and the wat securitization works, in the event of bankruptcy of the originator, the Special Purpose Vehicle (SPV) buys the assets of the originator and issues securities backed by the stream of payments. In Bankruptcy law, the purchase of the asset of the originator is compared to 'true sale', essentially allowing the estate of the originator to be separated in the bankruptcy proceeding[173].

In addition, another way the originator estate can be separated in the event of bankruptcy of the originator is to maintain, as it were, the SPV as a distinct, separate entity. When necessary requirements are fulfilled and the accomplying documents are updated, corporate statute of entities can guarantee that the SPV is separated from the originator's estate. Now, here is the challenge – how about if the SPV is the one filling its own bankruptcy suit? While this is a very valid worry, it can be prevented by having a procedural safeguard or measure. For instance, at the point of setting up the SPV, an internal corporate code may demand that all the directors of the SPV must unanimously agree on the ability or willingness of the SPV to personally file for bankruptcy. Thus, an external, independent director whose interests, particularly fiduciary interest, does not align with the rest of the board can be appointed. Thus, when there are no uniform interest, the possibility of colluding reduces. So the interests of the board is split into the shareholders' and the investors' – the SPV[174]. In addition,

[172] Michael J. Cohn (1998)
[173] Ibid
[174] Thomas S. Kiriakos et al., (2010) supra note 1, at 5-1, 5-172.3 to -184; Schwarcz, supra note 1, at 136

there can also be the strict performance obligation of the SPV to concentrates only on the immediate securitization purpose. When the SPV is not working outside the scope of the special purpose it is created for, it reduces the possibility of involuntary bankruptcy filing. When the SPV is directly involved in creditors other than those that are holding the issued securities, the possibility of filling for involuntary bankruptcy increases. It appears a bit contradictory that, if securitization was set up, in the first place by the originator, to prevent impeding bankruptcy, regulatory or corporate procedural code will allow it for bankruptcy to happen. Summarily, challenges emerge when the conventional doctrines are applied to securitizations. For example, as Kingston *Square Associates*[175] reveals,

[175] ''an influential bankruptcy court held that a debtor may orchestrate an involuntary bankruptcy petition for the purpose of avoiding bankruptcy remote bylaw provisions, gave the financial world reason to pause and reconsider the integrity of its various securitization transactions. The case involves an MBS – a mortgage-backed securities, just as in the case of the subprime mortgage of the financial crisis.
'' The significant parties in *Kingston Square* included two trustees, eleven debtors (all eleven debtors were controlled by the same person, the "principal"), and seven creditors who each filed an involuntary bankruptcy petition against the debtors.39 The trustees represented investors who were the beneficiaries of mortgage pass-through certificates issued by the debtors in a securitization transaction.' The mortgage certificates were similar to debentures in that they entitled the beneficiaries to a stream of future payments. For the purpose of securing the approximately $277,000,000 the trustees spent purchasing the pass through certificates, they took a mortgage on various properties owned by the debtors. As part of the securitization, the debtors inserted "bankruptcy remote" provisions in their bylaws.42 The provisions required a unanimous vote of the directors in order to file a voluntary bankruptcy petition.43 In conjunction with the unanimity requirement, the provisions also called for an independent director" whose purpose was, in part, to prevent the required unanimous agreement for the filing of a voluntary bankruptcy petition, thereby making the likelihood of a filing virtually nonexistent.' As the result of a default on the pass-through certificates, the trustees instituted foreclosure proceedings on all of the properties securing the certificates." The only way that the debtors were able to halt the foreclosures was through the filing of a bankruptcy petition and availing themselves of the protections of the Bankruptcy Code's automatic stay. Due to the bankruptcy remote provisions in the bylaws, the principal had to consider methods other than a voluntary petition to get each of the debtors into bankruptcy. In spite of the fact that the parties to the transaction specifically structured the securitization to avoid bankruptcy and did so at the behest of the principal, the principal gathered a group of "friendly" creditors for the purpose of orchestrating an involuntary petition against each of the debtors whom he controlled. The trustees moved for a dismissal pursuant to section 1112(b) of the Bankruptcy Code, arguing that each of the involuntary petitions was the result of collusion and therefore filed in bad faith. They argued that the principal "initiated, funded and identified seven friendly creditors to prosecute the involuntary petitions so each [d]ebtor could obtain improper leverage against the [trustees] by gaining access to the bankruptcy court without violating the bankruptcy restrictions in the bylaws of the various [d]ebtors."5 On the other hand, the petitioning creditors, in union with the debtors, claimed that seeking bankruptcy protection was their only means to (i) preserve any chance of recovery on their claims **...** before the [trustees] foreclosed on the assets of each [d]ebtor, (ii) challenge the validity of the [trustees'] claims, and (iii) find a third party to fund a plan of reorganization or purchase the properties, which would result in a greater recovery to all parties than would be obtained from the pending foreclosures. These arguments made by the petitioners appear to have some merit on their face but should be viewed in light of the following:

although a US decided case, securitization is somewhat peculiar that the direct application of conventional doctrines may become worrying.

The formation of a Special Purpose Vehicle (SPV) is primarily intended to be able to protect invest in the securities, although it may have a similar structure to any typical corporation. Thus, there is a danger of treating an SPV as any other corporation in certain matters, for instance in bankruptcy issues. While typical corporations are set up for the maximization of profits and wealth for its owners, the SPV aims at protecting its investors. Maximizing wealth doesn't fit into the narratives when, as often as it is, the sole shareholder of the SPV is the originator. This marked difference explains the

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The seven creditors the principal assembled for the purpose of this orchestration consisted of two trade creditors and five professional organizations (such as law firms and a consulting firm) whose overall debt was not significant enough to cause them, on their own, to file an involuntary petition prior to the solicitation by the principal. In addition, the principal paid a law firm to do the work, and several of the creditors were only willing to join in the filing of the involuntary petitions on the condition that the principal would handle all legal fees and administrative matters. One of the creditors had already written off the debt as "uncollectible,"' and only one of the creditors had taken any action beyond sending invoices to enforce its legal rights prior to the filing." Moreover, the assertion with respect to a greater recovery for all creditors excluded the largest body of creditors, the investors represented by the trustees, who had approximately $277,000,000 at stake. Finally, as the court noted: "Since these cases commenced, the Petitioning Creditors have exhibited no interest in what has been transpiring. And, of the seven individual creditors comprising the Petitioning Creditors, at least three had no knowledge of who was footing the bill for the legal expenses.

On this set of facts, the court correctly noted that "[a]t first blush, these cases seem ripe for dismissal." However, that statement is the closest the court came to acknowledging the questionable tactics employed

…by the principal. Aside from the fact that the case appeared "ripe" for dismissal, the court noted that "within the boundaries of well settled principles, a bankruptcy judge has wide discretion to determine if cause exists and how ultimately to dispose of the case.""8 Although that observation is true and would seemingly help to facilitate a just result, the court's opinion did not analyze the forces underlying this type of transaction, nor did it consider how ill-suited the case may be for adjudication based on "well-settled principles." Under this approach, the court's ensuing analysis tried to solve a new problem with old solutions and reached what many will argue is an erroneous decision, a model of form over substance… *The Kingston* court acknowledged that debtor orchestration of involuntary petitions is indicative of bad faith, but it held that orchestration standing alone is not enough for a bad faith dismissal based on collusion." As previously discussed, collusion requires concert of action and a fraudulent or deceitful purpose. According to the court, the orchestration of the petitions in this case satisfies the concert of action element of the test for collusion. However, since the concert of action was not for the purpose of avoiding a previous court order or in contravention of a statute, the court was unwilling to find the necessary fraudulent or deceitful purpose. The court interpreted "fraudulent or deceitful purpose" to mean "wrongful purpose."'' - Michael J. Cohn (1998) Asset Securitization: How remote is Bankruptcy Remote? Hoftra Law Review, Volume 26, Issue 4 Scholarly Common at Hofstra Law dynamics in the use of securitization and bankruptcy. This further buttresses the legal and regulatory challenges inherent in the use of securitization.

Naturally, asset-backed securities (ABS) have the distinct feature that makes them different from other contracts, for example secured debt. This feature, as explained above, makes ABS realize bankruptcy remoteness[176]. So the relationship securitization and bankruptcy law is such that, as explained above, more often than not, securitizations cannot be subjected to bankruptcy proceedings. Viewed from another angle, the traditional bankruptcy is somewhat restricted in securitization, particularly in cases that bankruptcy is replaced with specific liquidation proceedings.[177] This is because in securitization, when an SPV is set up, it is not unusual to have a structural guarantee that liquidation will be preceded by signs of distress than those actually lead to bankruptcy. One way to have it done is to have some caveat in the transaction document. Examples of earlier signs of distress could be when there is declining quality in the underlying assets pooled together, or when there is a downward review by rating agencies, but the real liquidation is when the value of liabilities exceed those of the assets. Furthermore, the party that performs the liquidation process is often not appointed by the court but is always a trustee who exercises the liquidation on behalf of the investors. With these marked differences in the conventional and securitization bankruptcy or liquidation processes, it is therefore a valid regulatory or legal challenge in adapting conventional bankruptcy principles in securitization cases and contracts. It is safe to infer that the specificities of how securitizations are structured do not have sufficient bankruptcy principles to match.

Securitization and Tort Liability

Securitization can be sophisticated and complex. A complete simple securitization can have layers of actors that paly different roles in interrelated and interdependent contracts. So a distinct feature, there are actors and players in a securitization contract. It is always in an interconnected web of relationships between the actors and the parties involved in securitization. In a typical securitization contract, there is the sponsor who most time doubles as the originator (but not compulsorily so, because there are instances that the sponsor is not the originator), the servicer and the depositor, the trustee (as mentioned above, who could be responsible for the liquidation of the Vehicle if circumstances necessitate such), underwriters and rating agencies, and the investors. These actors and

[176] Bankruptcy remote firms are those that are created to perform special project and separating financial risk and minimizing bankruptcy risks. They are typically prevented from incurring debts and obligations. They are also designed in a way that the bankruptcy has a little economic impact on the overall (or other) companies that it may be part of.

[177] Law of Transnational Securitization (2009)

parties paly different role in the smooth operation of a standard, typical securitization contract. In this interrelated web of players, when something goes wrong and there are losses at the end of the day, the investors only have contract with the SPV, which often time don't offer support. Should investors try to recover the loss via litigation, they can but establishing liability of the SPV in tort implies that the investors have to prove, at the very least, the dual failings of the SPV – false statements from the SPV that inaccurately coerced them into investing in the transaction, and either fraud or negligence on the part of the SPV while carrying out their duties. Either way, it is difficult in establishing liability.

In addition, there valid questions as to the interrelationships of the parties in terms of liabilities owe the investors. It is pertinent to ask if the parties involved in securitization have obligations to the investors. If indeed there are obligations, what constituents these duties? Who assigns them? Should they be standard procedure or to vary alongside the peculiarities of deals and securitization transaction? Understandably, these questions align with the investors protection motive and ultimately to the desired improvement of securitization and the intent of the Regulation EU 2017/4202.

Securitization and Substance-over-form

Understandably there are number of traditional doctrines of substance-over-form[178] that can be used in securitization. For instance, most SPVs are not sufficiently capitalized, and there have strong ties with the sponsor, and it is not unusual for the sponsor to be involved in the asset servicing, and often (with a posed stance in case of a possible default of the underlying assets) provide credit enhancement. However, in spite of these known features of securitization, it doesn't seem to be problematic yet for securitization. These features are what are considered in the conventional doctrines of substance-over-form, such as recharacterization of asset sales as secured transaction, veil-piercing, substance consolidation. This does portend some legal challenge for securitization.

Securitization and adopting the right legal nomenclature

There is some legal challenge to the way securitization can be described legally. This is because there are number of financial transactions and contracts that take the form of the idea of securitization but they are not directly termed thus. Getting the appropriate terminology for securitization (and perhaps

[178] Substance Over Form Doctrine is the doctrine, for example, which allows the courts or any other authority to ignore the legal form of an arrangement, or a firm as the case maybe, and to look to its actual substance in order to prevent artificial structures or firms from being used for untoward purposes

all other contracts and transactions looking thus. Securitization, being entirely a financial innovation and portend somewhat small legal challenge in providing the appropriate name. In addition, as a market and economic concept which is comparatively less widespread, there is the regulatory and legal challenge in concretizing it into a legal concept.

6.1 A critical Analysis of the implication of Regulation (EU) 2017/2402 on European Securitization Market

The Regulation (EU) 2017/2402 is laudable in many respects. There are however critical implication for the European Securitization market going forward. The European Commission's Capital Market Union has done quite remarkable job with the Regulation (EU) 2017/2402, particularly with the provisions to tackle the parts of the problems of securitization – lack of transparency and complexity. With the STS-securitization guidelines, a lot of improvement, security and confidence is expected in the European Securitization market. There are however legit concerns about the implication of the Regulation (EU) 2017/2402. I loosely categorize these concerns into two – the seeming difference between the narratives and contents, and sundry concerns. Under the sundry concerns, I identify potential implications and differences that will occur in the European Securitization Market, going-forward by January 2019. Under the discrepancy concerns, I identify ways that the narratives about the STS-securitization are seemingly different from the realities that will take place. Also specific elements of the Regulation (EU) 2017/2402 as well as the overall securitization regulatory changes are critiqued. For example, due diligence, retention, capital requirements, and the rating systems are critiqued.

The Concerns and Implications around Discrepancies

There seem to be noticeable discrepancy between the heralded intents of the CMU via the Regulation (EU) 2017/2402 and, in reality, what the Regulation will achieve. In the first place, the Capital Market Union (CMU) conceived the idea of the Regulation (EU) 2017/2402, in connection to the overall post-crisis intervention in the EU. For example, the CMU is concerned about the overall mobilization of capital in Europe and make the financial system across Europe to be resilient[179], and in particular in the reflection paper of May 2017 about the deepening of the economic and monetary union, the

[179] EC's webpage

reflection paper expects the amendments of the Regulation (EU) 2017/2402, with the hope that it will facilitate future securitization.[180][181]

Compared to the US, the post-crisis intervention in the EU, particularly the Eurozone, is somewhat underachieving[182]. The noticeable difference in the outcome and performance between US and the Eurozone post-crisis intervention, amidst many other reasons, is the over-reliance of the European banks on bank loans as against the US' system of market lending.[183] This means that after the financial crisis of 2008, many European banks were preoccupied with rebuilding their balance sheets, which the process, undermine their ability to solidly finance the Small-and-Medium-sized enterprises (SMEs). There is thus an urgent need to find a way to get an alternative financing medium and, using the US model, market-based lending arrangement seems appealing. The CMU, then, being in the main center of coordinating effective financial system across Europe needed to bring innovative financial techniques to bear, and open the financial markets via the stocks and bond markets. For example, in Germany, the real estates market is somewhat underdeveloped[184] and as such securitization portends to be a veritable tool to bring about the desirable turnaround, in line with the mission of the CMU. Thus to remodel the financing across Europe, the Commission tries to integrate European capital markets as much as practicable, standardize and harmonize the processes in the capital market[185], reduce the bureaucracies and *redtapism* around the capital market, and also revamping the European securitization market.[186] In addition to the compelling drive of the CMU to revamp the European securitization market, there are, on the other hand, other motivations to get securitization back on its feet, post-crisis. These motivations take the coloration of functions and politics. Political and functional reasons[187] that support the revitalization of the European securitization market can best explained as, for example, home owners and real estates market

[180] EC, 2017
[181] Gabor and Vestergaard (2018)
[182] Engelen and Glasmacher (2018)
[183] *Ibid*
[184] Compared to other markets with similar size of the economy, Germany wasn't doing well in the Real estates market, comparatively.
[185] For example, according to Engelen and Glasmacher, 2018, the process revamped include harmonized rule books for share and bond emission, prospectuses, and peer-to-peer lending.
[186] Engelen and Glasmacher (2018)
[187] Engelen and Glasmacher, 2018 believe that 'financialized real estate markets create their own political support once they reached a certain threshold' thus that stands as a sufficient political and functional reason to want the revamping of the securitization market. This personally makes sense to me: in that, after the financial crisis, and the identified problem of over reliance on European banks for financing of the SMEs, the securitization market offers an alternative funding mechanism. This tallies with possible socio-economic motivation for the revamping of the European securitization market.

participants who have economic incentives, would like to support the continuation of the securitization market, never minding the confluence of such intent with the CMU's mission.[188]

It is not unusual to have elements of governance through the financial market[189]. It does seem that the CMU is using its mandate of providing effective financial system of Europe, via policies of course, to achieve governing. To my mind, that's fine. As an American-style strategy, governing through the financial market entails the use policy goals that transcend the initial institutional capacity. In doing this, the CMU 'seeks realize a long-standing goal of the European policy makers: a financial system in which capital markets will absorb more citizens' savings and play a greater role in corporate finance', also increasing 'market-based banking, which also entails reviving the European securitization market'.[190] Thus, it is safe to conclude that the Regulation (EU) 2017/2402, albeit indirectly, is intended to be used to revamp the securitization market (which to my mind is good), however as a governing through the financial market technique.

Thus the naming of this section 'concerns discrepancies'. On the one hand, it seems the Commission, via the CMU, gives the narratives that the Regulation (EU) 2017/2402 is about having the STS-securitization, on the other hand, it is equally safe to deduce from the regulation that it can subtly be used as an alternative financing for European SMEs. It further gives the impression of a possible power play – the plausible interests carefully hidden behind the narratives and the contents of the Regulation.[191]

So far, as laudable as the Regulation (EU) 2017/2402 is, particularly the STS-securitization, another known discrepancy is the fact that the regulation seems to deal with the 'quantity' of securitization. In other words the STS-securitization deals with the process of how securitization is carried out with the reference to the tranching, structuring, distribution, and rating but little or nothing is done with the 'quality', as it were, of the securitization itself. This implies that the Regulation (EU) 2017/2402 has limited impact on the mortgage contracts themselves, since securitization is largely in form of

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[188] Engelen (2017) Fuller, (2015)
[189] Braun et al., 2018
[190] Braun B, Gabor D and Hu¨bner M (2018) Governing through financial markets: Towards a critical political economy of Capital Markets Union. Competition and Change
[191]'' Decision making in many policy domains is controlled by well-organized interest groups which tell 'trade narratives' that refer to public goods in order to obscure the private interests behind them (Bowman et al., 2017; Engelen, 2017). There is now a sizeable and growing literature that aims to explain the gap between narrative and facts as the outcome of power asymmetries. There is not only power in (policy) ideas, but also through and over them. In the latter two instances ideas are used to seduce or manipulate audiences into believing that private actions do indeed serve public values while they are actually harming them (see Carstensen and Schmidt, 2015; Engelen, 2017).''

derivatives hinged on an underlying assets. To my mind, while it is commendable that the regulation, particularly the frameworks on the STS-securitization, tend to increase the transparency, standardization, and simplicity about securitization, the underlying foundations and the contract the transactions are hinged upon are not so much impacted.[192] Examples that readily come to mind will be the absence of sections in the Regulation (EU) 2017/2402 that tries curtailing predatory lending[193] and ''socially unsustainable investment. This is so because of there is no limit (according to the Regulation (EU) 2017/2402) 'for loan-to-value or loan-to-income for the mortgages to be eligible for STS securitizations, even though these are the most important indicators for risk in mortgage lending'.[194] Understandably, high loan-to-value mortgage lending can be an innovative, fast-growing avenue of consumer finance, but it comes with great costs, to the economy and to the lenders[195]. When the lending policies and the management practices of lending (either high or low loan-to-value) is not considered in the eligibility of securitization according to the Regulation, then, that is concerning. This doesn't show significant difference from what was obtainable pre-crisis in the securitization market.

Another discrepancy is the label and what is obtainable. The tag STS-securitization presupposes the process and regulatory framework with will simple. The regulation's requirement doesn't seem simple with a lot of complex requirements. This observation tend to be commonplace.[196] By its very nature, being a form of derivative financing, securitization is traditionally complex, to the extent that,

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[192] Engelen and Glasmacher (2018)

[193] Practices and action that make the lender better off on the account of the borrower by carefully and deceitfully hiding details as fees, interest-rates etc.

[194] Engelen and Glasmacher, 2018

[195] Calomiris etal (1999)

[196] 'When the proposals for STS came along, I was a bit bemused as to how a set of such complex proposals could be labelled simple'. Rob Ford, TwentyFour Asset Management, Financial Times, 23 March 2016. Furthermore, Engelen and Glasmacher, 2018 perhaps pictures the discrepancy better. '' To illustrate their inherent complexity, take the passage that stipulates the types of documents that the different parties in any securitization (originators, structurers, sponsors, the managers of the special purpose vehicles used in securitization) have to provide to investors in order to fulfil transparency requirements. This adds up to a long list indeed, covering
more than four pages of the document, suggesting an ultimate file that could easily add up to more than a thousand pages, and would inevitably contain speculative assumptions about future risks, returns and macroeconomic conditions as well as open legal clauses such as 'in good faith'. Furthermore, the document explicitly requires the inclusion of interest and foreign exchange swaps in STS securitizations to manage interest and currency risks. However, derivatives hugely complicate the risk-and-return profile of any financial product, increase counterparty-risk and hence systemic instability, and allow banks to lever up their trading and banking books. As such, the draft proposal reads as if the notion of STS securitization has been stretched to 'cover' the industry practices that had developed before the crisis (for a detailed description of Dutch practices, see Glasmacher, 2018).''

by the framework of the regulation, securitization is now made for institutional investors and professionals. It is because of the inherent risks and complexities that informed the exclusion of retail investors. To my mind it seems there is a discrepancy between the nomenclature and the eventual reality of the securitization.

More subtle but nonetheless a discrepancy, is the fact of who actually benefits from the Regulation (EU) 2017/2402. As it stands, it is tempting to conclude that the Regulation (EU) 2017/2402 favours investors, and perhaps the entire financial landscape of Europe, however, on a more discerning look, there seems to be particular interests other than the most obvious. This is premise on the fact that it is possible for proposals that eventually gets to be Regulation (EU) 2017/2402 to be a function of cross ventilations of ideas, until a group consensus is made from the pool of ideas. This arrangement, called the 'garbage can' model of decision making[197]gives an impression that the outcome may not necessarily be the best idea, but just a reached consensus.

The proposals that eventually culminated into the Regulation seemed to have passed that process. It does seem that ulterior motives (or interests) are better served than the ones purported through the STS-securitization and the Regulation, because, more often than not, a proposal that culminates into a policy (as in this case, Regulation (EU) 2017/2402) could be arrived at if it serves particular interests of a larger coalition. This is because using this approach, consensus, 'coalition, narratives, contingencies and brokering are at the heart of this view of policy making, not rationality, problem solving, engineering, puzzling''.[198] The solution that STS-securitization proffers could extensively be serving the interests of European policy makers, central bankers, national banking associations, and regulators. While this may sound like a conspiracy theory, there seems to be evidence that these interests may as well be the ones being served by the STS-securitization.

First off, for the European policy makers, there are evidences that some of the policies in the EU are tailored, in some instances, after the US-model. For example, the overall Lisbon agenda, which one of its core objective is to 'investing more knowledge and innovation'[199] tend to be fashioned against the US venture capital-model of technological innovation seen in Silicon Valley[200] and the Services

[197] March and Olsen's (1989)
[198] Engelen and Glasmacher, 2018 and March and Olsen's (1989)
[199] European Committee on the Region (2005)
[200] Engelen and Glasmacher, 2018

Directive of 2006[201] takes the semblance of American shareholder-ideology[202] and the overall internal market arrangement of the EU copies, to a large extent the federal nature of the United States[203].

It is safe to conclude that the noticeable difference in the performance of the post-crisis interventions of the US and Europe could inform the subtle adoption of the STS-securitization as against what it is purported to serve. Secondly, there have been attempts by national banking associations – with the examples of Germany[204], Britain and the Netherlands[205] – with the intent to make securitizations to be more appealing to investors, a the seeming outcome that the STS-securitization, and by extension the Regulation. In Germany, for instance, the True Sale International[206] in Germany almost drive the securitization market of the German economy. It was initially founded by the association of national banks in Germany (at least 13 of them)[207] and nowadays with more partners in 'banks, consulting firms, service providers, law firms, rating agencies and business associations', which tallies with the same intent of the financial market promotion plan[208]. It doesn't feel like a coincidence that ideas of association of banks in Germany and those of the STS-securitization tally. It is most likely as a result of subtle agenda guised in the form of STS-securitization. Thirdly, the central bankers also tend to be culpable in the seeming discrepancy. This seen from the perspective where post crisis intervention of central bankers (in this instance, the ECB and the BOE) tend to be on the concentration on 'negligent risk management rather than on concerns such as misallocation of credit, asset bubbles and other microprudential issues, as occasioned by the May 2014 Bank of England/ECB Discussion.[209]

Closely related to the central bankers, are the roles regulators (especially The European Banking Authority) also play in the discrepancy. For example, while highlighting the benefits of securitization, there is little or nothing that is mentioned in the complicity of securitization in the financial crisis. Either it is deliberate or an oversight, it gels with the idea that the drawbacks of securitization are deliberately ignored in the quest to sell the STS-securitization agenda. Further concerning is the fact that before the eventual tag of STS-securitization, the EBA supports the initiative to have a centralized European securitization standard via '*'Prime Collateralized Securities initiative'' (PCS).* The worry

201 EC (2006)
202 Engelen and Glasmacher (2018)
203 Milward (1984)
204 https://www.true-sale-international.com/
205 https://www.dutchsecuritisation.nl/
206 https://www.true-sale-international.com/
207 Engelen and Glasmacher (2018)
208 *Ibid*
209 Engelen and Glasmacher (2018) provides more information on the role of the Bank of England and the ECB, in a possible intentional creating the discrepancy.

is the play on words – Prime to mitigate *Subprime* – a word that it clearly associated with the financial crisis.[210] These concerns show discrepancy in the way the intent of securitization is projected than what, empirically analyzing, it is in reality.

In the same vein, major elements of the regulation (EU) 2017/2402 can be individually critiqued. For example, Regulation (EU) 2017/2402 emphasizes disclosure, but it is doubtful if increased disclosure can ultimately by itself result in better securitization transaction. I arrive at this position because, pre-crisis, disclosure were demanded for securitization transaction, and still we had the financial crisis. Some securitization transaction are rather complex that disclosure in itself may not achieve much.[211] Similar reasoning can be extended to risk retention. Since risk retention is to mitigate moral hazard associated with the originate-to-distribute model[212] , it is arguable if legally requiring risk retention will improve the quality of the financial asset itself. This corresponds with my earlier argument about cosmetic approach with rather shallow impact of the quality of the underlying financial assets. Lastly, it still unclear if the due diligence requirements of Regulation (EU) 2017/2402 are remarkably different from the due diligence of other parties in securitization, from example trustees. If the due diligence isn't different, it is most likely to be unnecessary.[213]

Sundry Concerns

The regulation no doubt has some merits in that the new framework repeals existing securitization and it limitations. Had the present securitization regulation been flawless, there would not have been reason for another. However, the existing body of law namely- Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 also have some good provisions. With the new regulation totally repealing the existing one, the good of the present body of body of law are somewhat discarded. That is somewhat concerning. In addition, the new Regulation (EU) 2017/2402 (and its twin – the Regulation (EU) 2017/2401 – the Securitization Prudential Regulation, SPR)[214] combine the collaged legislation on securitization. While the former emphasizes the introduction of the STS-securitization, the latter replaces the provisions of the Capital Requirement Regulation and investment firms. Before the Regulations go live in 2019, what is currently obtainable is that the set of rules that applies are dependent on the type of investor. As it is

[210] Engelen and Glasmacher (2018)
[211] Schwarcz (2016)
Some securitization structures are equally complicated that, for example, the sheer amount of information to be disclosed or technical financial jargons included in a Prospectus may just make investors to rely on credit-rating institutions.
[212] Schwarcz (2016)
[213] Ibid
[214] Both Regulations – (Regulation (EU) 2017/2402 (the Securitization Regulation) and Regulation (EU) 2017/2401 (the Securitization Prudential Regulation, or SPR) or expected to work hand-in-hand. But this focus of this thesis is essentially on the former.

under the new Regulation (EU) 2017/2402 (the Securitization Regulation), all investors are classified essentially as institutional investors. Going forward, retail investors can't, as per the provisions of the requirement of the Regulation (EU) 2017/2402, engaged in securitization in Europe. Understandably, the Regulation is for protection of investors (amongst other things) but outright shutting out of retail investors is a concern.

Another concern about the Regulation (EU) 2017/2402 is the fact that some STS-securitization in Europe might profit from favorable capital treatment, while others wouldn't. It does seem the regulation, perhaps unknowingly, is not giving a level playing field. A major instance is the application of the eligibility criteria for STS tag. I understand the fact that securitizes are to be motivated to get the STS tag, however, the unequal level playing ground is somewhat a legit concern. A major instance is the application of the eligibility criteria for STS tag. The criteria are somewhat similar for securitization and ABCP transactions. While for securitization, at least, underlying assets are expected to have similar characteristics and be homogenous in terms of cash flows nature, contracts, and credit risks; for ABCP transactions, the similar criteria are also demanded only that there are derogation of the law for specific sector – the auto industry. ABCP transactions are expected to have homogenous characteristics, for instance the maturities of underlying assets pool. To be considered eligible for the STS tag, ABCP transactions are expected to have pool of asset with the remaining weighted average life of not more than a year, and that the with no transactions that may have residual maturity of longer than three years. Here is the unfair treatment, the auto industry (understandably one of the largest sectors that use the ABCP transaction) has a derogation of the law to allow the exposure weighted average of up to three and half years, and provided the underlying assets has a residual maturity of longer than six years. In derivatives generally, and securitizations in particular, the difference between length of time given to the auto industry can make a lot of difference in terms of revenues and turnover. A regulation that unfairly favors some sectors over others can be concerning[215].

By way of derogation from the second subparagraph, pools of auto loans, auto leases and equipment lease transactions shall have a remaining weighted average life of not more than three and a half years, and none of the underlying exposures shall have a residual maturity of more than six years – Art 24 (15)p3

Another way to illustrate the unleveled playing field of the regulation is that fact that not all securitizations benefit from preferential capital treatment. For instance, Commercial mortgage-

[215] Article 24 (15)

backed securitization (CMBS) are exempted from the STS eligibility criteria. It seems contradictory on many counts, at least to my mind. The reason for the exclusion is exposures and risks concerned because there is reliance on the sale of the underlying loans to repay the CMBS obligations. Now, if the new Regulations in all about fostering transparency, simplicity and standardization as claimed, CMBS with the identified flaws should be those to be included in the STS-securitization eligibility criteria and not excluded. This is concerning, to my mind. In the process ‘‘ While better capital treatment for some products is certainly welcome, it is discouraging that a large number of securitizations that have performed historically well (such as some synthetic or more actively managed structures) will continue to be disadvantaged relative to more traditional ABS and ABCP’’[216]. There are also other instances of this unfairness[217] and there are rather concerning.

In addition to the above named concerns, it is also noteworthy to mention the third party verification and its limitation. As mentioned already, Originator, Sponsor and SSPE may use the service of an authorized third party to check whether a securitization complies with the STS criteria. However, the use of such a service shall not under any circumstances affect the liability of the Originator, Sponsor or SSPE in respect of their legal obligations under the Regulation nor the due-diligence obligations imposed on Institutional Investors. This means that, based on the assessment of a third party, the STS tag may be given. It is worrying and concerning. It seems to me that the system will potentially work like rating agencies. In the wake of the financial crisis, the roles and functions of the rating agencies and their culpability is still fresh. Then, rating agencies approved (for whatever reason) sub-primes mortgages as prime. Now, after the introduction of the Regulation, same dynamics of third party verification can toe the line of the rating agencies and their flawed assessment pre-crisis era.[218]

[216] Norton Rose Fulbright (2018)

[217] ‘‘ In its 2015 report to the Commission on synthetic securitization, the European Banking Authority (EBA) recognized that synthetic transactions that are used by credit institutions to transfer the credit risk of their lending activity off-balance sheet (i.e. balance sheet synthetics) have performed relatively well. The EBA recommended extending preferential regulatory capital treatment to senior retained tranches of synthetic transactions, provided that specific criteria are satisfied. Among other things, the transactions would need to be comprised of fully cash-funded credit protection provided by private investors in the form of cash deposited with the originator institution.
At the time, the Commission was reluctant to introduce eligible STS synthetic products on the basis that it lacked sufficient information to take a view. Currently, despite being armed with the EBA’s recommendations, the Commission appears to have compromised with the European Parliament on this issue. However, the Securitization Regulation does contemplate the possibility of including synthetic products in the future’’ - Norton Rose Fulbright (2018)

[218] Admittedly, some undertakings are exempted from being third party assessors - Credit institutions, investment firms, insurance undertakings and credit rating agencies are not eligible to act as third-party certification providers.

Another worry is about the legacy assets that are used in securitizations. When Regulation is fully operational, the securitization transactions are expected to be STS-securitizations, including legacy securitizations, at least in theory. Legacy assets are generally defined as assets that have been on the books of companies for a long time and have degenerated value over the time. Some of legacy assets are also used in securitizations. Now, here is the concern: from the January 2019 legacy securitization, previous legacy transactions can potentially be tagged STS, should they fulfill the criteria. Fulfilling criteria doesn't totally remove what they are! Since the underlying legacy assets are involved, in my opinions the exposures are still much as valid as when they are now tagged STS.

Lastly under the sundry concerns about the Regulation, sanctions may be dissimilar across the EU. It is concerning that when the Regulation eventually comes underway, the harmonized set of rules would not count as administrative and criminal sanctions regarding the braches of the Regulation will be subjected to Member States' interpretations and peculiarities. For instance, it is possible for a similar breach (say for example, the breach of providing wrong data and information), defaulters in a particular country could be severely punished than another in a different member state. This is so because the use of discretion.

This so much for a Regulation that wants to harmonize the operations of securitizations across the region, particularly with the acclaimed 'simple, transparent, and standardized' characteristics. Regulation merely expects the sanctions to be "effective, proportionate and dissuasive". They must take into account whether the infringement was intentional or resulting from negligence, and must take into account the materiality, gravity and duration of the infringement. While taking into account intention or negligence suggests a move away from strict liability for non-compliance, the sanctions framework creates a minefield of compliance issues that could discourage cross-border securitization and runs contrary to the stated aim of CMU''[219]

The verification seems worse with the SPR. There are two-fold test or assessment to be carried out. '' First, the transaction must satisfy a separate set of prudential eligibility criteria. For example, the underlying assets must not, on their own, have a risk weighting above a prescribed set of thresholds. Second, the transaction must meet further criteria, such as maximum borrower concentrations and loan to value limits'' - Norton Rose Fulbright (2018)

[219] Norton Rose Fulbright (2018)

7. Conclusion

The EU, in its green paper on Building a Capital Markets Union[220], in February 2015 has listed building a sustainable securitization (alongside widening the investor base for SMEs, lowering barriers to accessing capital markets, boosting long term investment, developing European private placement markets) as one of the priorities for early action in terms of its resolve for reawakening economic vibrancy in Europe. It defines securitization as 'the process by which assets such as mortgages are pooled together for the investors to invest in' and this paper examines the evolution of the securitization in Europe, the current summary of EU legal acts that deal with securitization (essentially the CRR iv), it potentials and present problems, as well as the panacea for its current impairment after the financial crisis.

When structured and applied well, Securitization has enormous economic and social benefits. A well-structured and functioning securitization market help as an investment avenue for financial institutions and investors. It is also a viable funding instrument to foster lending to banks and other investors. Securitization also acts as a medium to generate collateral for credit demands, by its ability to transform illiquid receivables and loans to more liquid assets. However, following the financial crisis, and the role played by securitization, there is still a lot of stigma associated with securitization. In response to the financial crisis, the European Parliament and the Council of the European Union, at the end of 2017, passed the general framework for securitization in Europe. The frame work entails elevating the process of securitization to be transparent, simple, and standardized.[221] The regulation, coming into force by 2019, also doubles as an amendment to Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

The crux of the regulatory response in Europe is to incentivize people to participate more in securitization, especially opening up the process to be simpler and transparent. The European Parliament and Council proposed the framework that eventually culminates to the Regulations (EU) 2017/2402 and 2017/2401. The former relates to the securitization regulation in itself while the latter relates to the amendments in the existing capital requirement regulation. On a global scale, there are also coordinated efforts to strengthen securitization.

[220] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=COM:2015:63:FIN&from=EN
[221] Regulation (EU) 2017/2402.
The acronym STS is duped for the securitization that will be simple, transparent and standardized, Regulation (EU) 2017/2402

The Regulation 2017/2402 essential contains two divisions – the general framework and specific requirements for the criteria for securitizations that are simple, transparent, and standardized. The general framework includes requirements like due diligence, risk retention, and transparency.

Due Diligence requires institutional investors to verify certain components of the securitization transaction, prior to holding a securitization position. The crucial elements include the credit-granting process of the originator[222], the adherence and compliance of the originator to risk retention requirements, regular provision of required information by the originator, and the risk characteristic and structural traits that are to be in accordance to written processes, both to be initially written and those to be added on ongoing basis. If the originator or the original lender is not a firm established in the European Union, the due diligence is perhaps more pronounced as the credit-granting process as to be sure to be in compliance with 'sound and well-defined criteria' of creditworthiness, and effective credit financing systems. It also expects thorough assessment of the risk profile of the securitization positions to be held, regardless if such securitizations are supported with the ABCP Programme or otherwise, particularly as it affects the underlying exposures. The due diligence requirement of the institutional investor is obviously an encouraging, novel addition. However, apart from the fact that due diligence is an additional burden on the institutional investor, it is yet to be seen if it changes anything remarkably, as the due diligence requirement is not essentially different from due diligence of other parties, (say for example the trustees) in a securitization transaction.

The general framework also requires expects the interests of the originator, the original lender or the sponsor align with those of the institutional investor. To therefore attain this, the Sponsor, Originator, or the Original Lender is expected to retain significant net economic interest in the securitization on an ongoing basis. This is the risk retention aspect of the regulation. It essentially captures the reduction of the moral hazard involved in the originate-to-distribute model of securitization. The net material economic interest is not expected to be less than 5% of the notional value of the origination, for off-balance sheet items. Of course, to reflect the true state of the value, the net economic interest is not supposed to be subject to hedging, or any credit-risk mitigation. It is only one party that is expected to have the risk retention. In the event that it turns out that there is no agreement on the basis for risk retention, the originator then is obligated to fulfil all the risk retention requirement. That way, there would not be a split that could potential reduce the actual risk retention percentage of the net economic interest. In addition, to safeguarding that there no split, there isn't supposed to be any multiple applications for the retention requirement. Entities that are created or that operate in

[222] Particularly so, if such credit granting firm is not established in the European Union.

securitizing exposures wouldn't be qualified to be originator. These requirements seem to be clearly thought-out ones by the drafters. In securitization transactions, risk retention can be hugely avoided with many technical procedures – some of which the Regulation frowns out: Split and multiple applications.

Transparency part of the general framework hopes to forestall a reoccurrence of the events of the global financial crisis, by having a higher sense of transparency and information sharing on the part of the originator, Sponsor, SSPE etc to the institutional investors. The originator, sponsor or the SSPE are obligated to provide the institutional investors (even before concluding and holding the securitization position) on a regular basis with sufficient information that are material for the informed decision of holding the securitization position. The frequency of the information may vary depending on the types and class of the securitization. For example details about the underlying exposures and documentations[223] are vital enough to be provided to the investors, and they are to be provided on a quarterly basis. Fine line and details are not to be left-out, say for example, information about the description of the payment priority. The information sharing is expected to be compact, and comprehensive, as the originator, sponsor, and SSPE make available the information through a securitization repository.

The specific framework of the Regulation relates to the criteria for the simple, transparency and standardized tag. To be simple, the title to the underlying exposures is only to be acquired by the means of true sale or assignment or transfer with the same legal effect in the manner that is enforceable against the seller or any other third. That way, complicated ownership structure are avoided. Plus, In addition, the assets are to be homogenous in nature and no resecuritization is allowed. To be transparent, the inner workings of securitization is opened up, and information sharing is encouraged. Investors are to be avail information for them to make informed decision about the securitization transaction. The requirement makes sure that at least 5 years of data to be made available. The standardization phase of the STS criteria bothers on structural elements. It requires that

[223] Important documentations like the final offering document or the prospectus together with the closing transaction documents, excluding legal opinions, sale agreement assignment, novation or transfer agreement and other relevant declaration of trust, the derivatives and guarantee agreements, as well as any relevant documents on collateralization arrangements where the exposures being securitized remain exposures of the originator; the servicing, back-up servicing, administration and cash management agreements; the trust deed, security deed, agency agreement, account bank agreement, guaranteed investment contract, incorporated terms or master trust framework or master definitions agreement or such legal documentation with equivalent legal value; any relevant inter-creditor agreements, derivatives documentation, subordinated loan agreements, start-up loan agreements and liquidity facility agreements;

the risk retention part of the Regulation must be adhered to by the originator, and sponsor. It also expects that the currency risks and interest risks by mitigated. In all to be standardized, there will be elements of comparability across board.

Welcoming as the Regulation may seem, there are concerns. The thesis categorizes these concerns into two – difference between the narratives and contents, and sundry concerns. Under the sundry concerns, the thesis identifies potential implications and differences that will occur in the European Securitization Market, going-forward by January 2019. Under the discrepancy concerns, the thesis identifies ways that the narratives about the STS-securitization are slightly different from the realities that will take place.

Regardless of the regulatory interventions up till date, the securitization in Europe is still underachieving compared to the US securitization. Specifically, the Regulation seems to deal with the 'quantity' instead of 'quality' of securitization. For example, STS-securitization deals with the process of how securitization is carried out with the reference to the tranching, structuring, distribution, and rating) but little or nothing is done with the 'quality' of the securitization in terms of laws concerning the structure of the underlying assets. It is worrying that that the Regulation has limited impact on the mortgage contracts themselves, since securitization is largely in form of derivatives hinged on an underlying assets. In addition, the Regulation seems to structurally favour investors over other parties in a securitization transaction, apart from the fact that the rules in the Regulation are not as simple as the title suggests. All in all, the landscape of European securitization market will change from 2019. Time only can tell if the Regulation 2017/2402 can make the significant difference in preventing another securitization-induced crisis.

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